



The Importance of Being Capitalized

Patricia Born*

Efforts to encourage insurers to enter the Florida homeowners market do not appear to be meeting their objectives. The attractiveness of coverage offered by private insurers is putting consumers at an even greater risk as the premiums collected and available capital will likely prove insufficient for paying claims. Florida has severe exposure due to undercapitalized companies, which has placed the state insurance system and economy in great peril.

Background

For a variety of reasons, insurance companies face more regulation than most other companies. Their pricing practices, policy forms, investment activities, and marketing techniques are closely monitored, and sometimes dictated, by state regulators, with an emphasis on consumer protection. Perhaps the most important goal of insurer regulation, however, is guaranteeing that insurers are able to pay claims when losses occur. This is especially important in the Florida homeowners market, where losses due to hurricanes affect a large share of the population simultaneously.

Insurance regulators use a combination of tools to evaluate insurers' ability to pay claims. For example, regulators review financial statements to better understand the insurer's liabilities and the capital available to support these liabilities. Initially, insurers must meet minimum capital requirements to operate in the state. For property insurers

* Patricia Born is Robert L. Atkins Professor and Director for the Center for Insurance Research Department of Risk Management/Insurance, Real Estate and Legal Studies at the Florida State University - College of Business. She is also an insurance public policy expert for the American Consumer Institute Center for Citizen Research in Washington, DC.

in Florida, the amount required, before any policies are written, is currently \$5 million.¹ Once an insurer begins selling policies, required capital is evaluated using complex formulas that consider the riskiness of the insurer activities, recognizing the policies written and the investment portfolio, among other things. But while this information is easily accessible, the determination of insurer solvency is not an easy task. Insurer liabilities are largely estimated, and the insurer's capital, also known as *surplus*, may be tied to many other uses. Further, insurers enter into complicated reinsurance arrangements for additional support.

As hurricane season begins, it is important to ask if Florida insurers have the capital needed to pay claims. For several years now, it has become increasingly apparent that premiums paid by Florida homeowners are generally inadequate given the insured risks, as regulatory policy has placed greater importance on suppressing prices than it has in making sure capital is sufficient to pay claims.² This distortion has been further complicated by the application of mitigation credits to base rates that are not adequate to begin and have not been administered properly to reflect actual data.³ This year, concerns are elevated by the persistence of the financial crisis and the Deepwater Horizon oil spill, which have put still more financial pressure on the state. The state insurance programs, Citizens Property Insurance, which accounts for 28 percent of Florida homeowners' premiums, and the Florida Hurricane Catastrophe Fund ("Cat Fund"), which provides backup coverage to insurers, have the ability to borrow money to pay claims.⁴ But it is unclear whether the private insurers have adequate capital to cover claims if the state should experience major hurricane losses this season.

¹ Senate Bill 2044, vetoed by Governor Crist in early June, would have imposed a higher capital requirement of \$15 million for homeowner insurers by 2015. Current insurers are required to hold only \$5 million.

² See "Granularity in the Florida Property Insurance Market," Florida Catastrophic Storm Risk Management Center White Paper, August 1, 2009.

³ See Report of the Florida's Commission on Hurricane Loss Projection Methodology's Windstorm Mitigation Committee, February 2010.

⁴ Recent estimates suggest borrowing capacity of the Cat Fund is \$16 billion. The fund can place an assessment on about \$33.3 billion worth of premiums collected by insurance companies in Florida.

The Data Reveals an Alarming Trend

Recently, a report examined the individual property-casualty insurers writing homeowners coverage in the state in 2008.⁵ The authors determined that out of 141 companies with positive premiums written, 62 were domiciled in Florida, and 79 were domiciled in other states. Companies domiciled in Florida must meet certain regulatory requirements established by the Florida Insurance Commissioner, who is also responsible for monitoring their solvency. Non-domiciled insurers are subject to solvency regulation and monitoring in their state of domicile. Interestingly, most of the Florida domestic companies are not affiliated with a larger group.⁶ Group affiliations among insurers vary in design, but most suggest an additional level of support for the subsidiary in the form of capital infusions, support agreements and guarantees.

A review of the same data for 2009 suggests that availability of private coverage has not improved since 2008. The number of individual property-casualty insurers writing homeowners coverage in 2009 fell to 133. Of these, 59 were domiciled in Florida, and 74 were domiciled in other states. Most striking is that several companies were declared insolvent or troubled earlier this year, despite a hurricane-free year of underwriting. These exits are not only a problem for homeowners with unpaid claims; insolvencies create an additional burden for policyholders who have to shop around for new coverage.

The authors of the mentioned study examined, among other things, the premiums and surplus of all the companies operating in Florida. They note that Florida's domiciled homeowners insurers wrote 61.2 percent of the premiums and yet held only 3.1 percent of the available policyholder surplus among the state's homeowners writers. Policyholder surplus is the excess of capital over the insurer's estimated liabilities, and

⁵ "Analysis of Florida Homeowners Insurance Market: Chasing Out Private Capital Means Reliance on Small Domestics," American Insurance Association Policy Development and Research, August 2009.

⁶ The authors emphasize that unaffiliated domiciled homeowners writers had 84.7 percent of their overall premiums in Florida homeowners line in 2008. Affiliated homeowners writers had only 41.7 percent of their premiums in this line. This suggests that affiliated domestics are more diversified and have less exposure to Florida property risks.

serves as the financial safety net when claims exceed premiums.⁷ Non-domiciled companies wrote nearly 25 percent of the premiums in 2008, but accounted for 93.5 percent of policyholder surplus.

Where Things Stand Today

The data for 2009 show that this situation has not improved. Florida's domiciled homeowners held a slightly larger share of the market in 2009, with 64.3 percent of the premiums, and yet held only 2.9 percent of the available policyholder surplus among the state's homeowners writers. Non-domiciled companies wrote just over 24 percent of the premiums in 2009, but accounted for 92 percent of policyholder surplus. The market share of premiums written by Citizens declined from 14.3 percent in 2008 to 11.4 percent in 2009, reflecting the movement of policyholders out of Citizens to private insurers.⁸

Interestingly, the total amount of surplus reported by insurers operating in the Florida market increased, in real terms, from 2008 to 2009. Non-domiciled companies saw an increase in capital of nearly \$8 billion, while the surplus of the domiciled insurers fell by about \$365 million total. Thus, while the total capital available for paying Florida homeowners claims has increased, the capital that is dedicated more specifically by Florida insurers to their operations has declined.⁹

The imbalances between capitalization, state of domicile and market share are not necessarily a cause for alarm. However, to the extent that capital supports insurers' operations in other state markets and other lines of insurance, the availability of capital from non-domiciled firms to cover catastrophic losses is limited.¹⁰ Thus, a company

⁷ The authors of the study note that when the premiums collected by Citizens are included, Florida domiciled companies have roughly 75.5 percent of the market but only 6.5 percent of the policyholder surplus among Florida homeowners writers.

⁸ At the end of 2009, Citizens had 16.1 percent of all personal and commercial residential policies in force in Florida.

⁹ Many of the insurers domiciled in Florida operate in other states and other lines of insurance; thus, their reported capital is not tied exclusively to supporting property risks.

¹⁰ Note that the use of alternative sources of funding, e.g., via the capital and reinsurance markets or through affiliate relationships, varies across insurers. These activities can significantly reduce reliance on internal capital, but due to their complexity, they are not considered here.

with a small share of the Florida market, but a large amount of capital is not necessarily “safe” from insolvency (and more likely to meet claim obligations), but it is “relatively safe” when compared to the company with a large market share and a small amount of capital. Looking across insurers operating in 2009, the ratio of premiums to surplus is greater than one for nearly 40 percent of the insurers operating in Florida.¹¹ A higher ratio of premiums to surplus indicates that an insurer is more likely to have insufficient reserves for paying claims that exceed expectations. Insurance premiums are intended to cover expected claims payments, and include an allowance for administrative expenses and profit. Basically, if surplus is just as large as premiums, the insurer has the means to pay claims that are twice as high as expected. This level of support is not likely to be adequate for paying catastrophic losses from hurricanes, which may be many times the expected loss.

Summary

Efforts to encourage the formation of new insurers in the state and move consumers out of the state insurance program do not appear to be meeting their objectives. Citizen’s market share has declined slightly, but Florida homeowners have seen little improvement in the availability of coverage, and the attractiveness of rates offered by private insurers is only putting consumers at an even greater risk as the premiums collected and available capital will likely prove insufficient for paying claims.

Note: All 2009 insurer data taken from NAIC Insurer Annual Statement Data via SNL.

###

About The American Consumer Institute Center for Citizen Research

The Institute is a nonprofit educational and research institute. For more information, visit <http://www.aci-citizenresearch.org>.

¹¹ Among insurers domiciled in Florida, this number increases to 44 percent.