**Real Reform for Louisiana Citizens Property Insurance Corp.**
By Eli Lehrer

Louisiana's Commission on Streamlining Government has recommended phasing out the Louisiana Citizens Property Insurance Corporation.[1] The proposal—still in its embryonic stages—would recreate the Joint Underwriting Association (JUA) structure that existed before 2003. To do this, the commission has recommended removing Citizens from state government and creating an entity outside of government that would take on its responsibilities.

This paper explains the proposal and offers guidance for policymakers as they consider various proposals for Citizens' future. Following an introduction that explains the basic facts about "markets of last resort" (entities like Citizens) and what the proposal would do to Louisiana's existing market, the paper introduces four fundamental principles policymakers should keep in mind as they consider the potential of overhauling Citizens.

## What Citizens Is

Understanding the proposal requires some background on Citizens. Fundamentally, Citizens is an "insurer of last resort" or "residual market insurer." Such an insurer serves to write coverage to homeowners who cannot find private market coverage in the "voluntary" market.

Homeowners can have trouble finding coverage from purely private companies for two major reasons. First, states sometimes do not allow private insurers to charge rates that allow them to have any assurance of making money (or even breaking even) on a policy in a given location. Second, a small number of properties are so risky that many private insurers simply won't write policies for them at any price.[2]

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[1] Commission on Streamlining Government. "Proposals," http://senate.legis.state.la.us/Streamline/m_recommendations.asp

In principle, very few observers consider it desirable for these markets to become very large: Laws in all 50 states require state governments to approve "adequate" rates for insurance companies and, so long as a strong possibility of at least breaking even exists, some company will eventually write a policy in any location.

Nonetheless, every hurricane-prone state, most states with earthquake risks, and most states with deteriorated, high-crime urban areas maintain some sort of residual homeowners' insurance market. Some are very small and others quite large. Florida, for example, writes nearly one in five property insurance policies in the state through the Florida Citizens Property Insurance Corporation. Washington State, by contrast, writes a total of 52 homeowners' insurance policies through its residual market mechanism.

No two states have identical laws governing how these plans work, exactly what type of coverage they write, and how much they charge for it. The Commission on Streamlining Government would change the legal status (although not necessarily the duties) of Louisiana's market of last resort. In particular, the Commission has suggested moving Citizens out of state government while retaining the concept of a market of last resort for people unable to find insurance elsewhere.

Although state laws mandate that property insurers take part in a JUA and contribute to its operations, a JUA is incorporated as a private, not-for-profit business and run by a board selected by the industry and (usually) insurance regulators. In insurance circles, people generically call such private, government-mandated operations "FAIR (Fair Access to Insurance Requirements) Plans."[3]

Louisiana Citizens, on the other hand, is an agency of state government—a government corporation—although it is exempt from some rules that bind other government agencies.[4] Two other states, Florida and California, have residual insurance markets that operate as integral parts of state government.

Fundamentally, the commission wants to phase out Citizens because the organization in its current form has imposed significant costs on taxpayers.[5] All current property

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[2] All sizeable insurers "portfolio" risk by pooling together similar risks that are unlikely to make claims at the same time. When a risk is particularly extreme, insurers sometimes have a difficult time trying to find another "like" risk to portfolio with it and thus, even if given enough premium, may not want to write it. Of course, given enough time and the ability to make money, it's highly likely that somebody will take the risk.

[3] They also have a variety of other names including "Beach Plans," "Wind Plans," "Wind Pools" and "Property Insurance Associations."

[4] Louisiana Citizens Property Insurance Corporation, "About Us," http://www.lacitizens.com/CompanyOverview.aspx

[5] See, for example, Jan Moller, " Louisiana Citizens Property Insurance Corp. should be phased out, streamlining panel says," *New Orleans Times-Picayune,* December 8, 2009, http://www.nola.com/politics/index.ssf/2009/12/louisiana_citizens_property_in_1.html

insurance policy holders pay special taxes ("assessments") to fund payments on the $1 billion in state bonds the state issued to finance Citizens' deficits following the 2005 landfalls of Hurricanes Katrina and Rita.[6] Since it is part of state government, it's clear that bonds can be issued on Citizens' behalf. A private entity, on the other hand, would not necessarily be able to get the state to issue debt on its behalf.

If another major hurricane hits, there's a good chance Louisiana would issue more bonds to support Citizens. Citizens' status as a part of state government means the corporation almost certainly would be bailed out if it ran into trouble again. (Indeed, the state might have a problem selling debt for other purposes if it refused to bail out Citizens.) Members of the commission also hope a private entity would be better run and overcome many of the management problems—including a very likely negative audit before the end of 2010—that trouble Citizens.[7]

Given the potential risks and rewards, a case does exist for changing the way Louisiana's residual market works. If policymakers move to phase out Citizens or otherwise change its form, they should keep four things in mind:

1. The legislature should make certain that whatever it creates to replace Citizens continues Citizens' policy of trying to shrink itself and not competing with the private market.

2. Simply separating Citizens from the state government will not necessarily protect taxpayers from having to bail out whatever replaces it.

3. If it's restructured as a JUA or something else, the legislature should carefully monitor the new entity and subject it to some types of state ethics and open government rules.

4. If it wishes to protect taxpayers from the potential liabilities of a new JUA, the legislature may wish to mandate that the JUA purchase private reinsurance at the "1 in 250 years" catastrophic event level.

## 1. The legislature should make certain that whatever it creates to replace Citizens continues Citizens' policy of trying to shrink itself and not competing with the private market.

Although it certainly imposes costs on state taxpayers and has management problems, Citizens currently does appear to function as a true "market of last resort" for people who cannot get coverage elsewhere. The legislature should make sure that Citizens, however it is reformed or restructured, keeps doing this.

[6] Ibid.

[7] Ed Anderson. "Citizens Insurance Agency can expect negative audit," *New Orleans Times-Picayune,* November 12, 2009, http://www.nola.com/politics/index.ssf/2009/11/post_139.html

Under policies of governors Kathleen Blanco and Bobby Jindal as well as Commissioner James Donelon, more private companies have entered the state, and companies already in the state have been willing to write more policies. Citizens has encouraged "takeouts" from private companies in a successful effort to reduce the number of policies it writes.[8] Nonetheless, given the ability to charge rates more in keeping with risks—something the current insurance department in Louisiana has generally proven willing to let insurers do—it's possible some insurers would take even more policies out of Citizens and thus transfer even more of the risks of Louisiana's coastal vulnerabilities from state taxpayers to private investors.

Citizens remains bigger than it probably should be. Currently it writes property insurance for approximately 2 percent of Louisiana's residents.[9] Only three states—Texas, Florida, and Massachusetts—maintain residual insurance markets larger than Louisiana's. [10] All other states with residual property insurance markets place a smaller percentage of policies into them.

Thus even though it is moving in the right direction, Louisiana still has a long way to go. If it moves Citizens outside of state government, the legislature should make sure not to do anything (such as requiring a new entity to lower its rates) that would put it into direct competition with the private market. In fact, the legislature should look for ways to make sure that a new entity continues to follow many of the policies Citizens currently does.

**2. Simply separating Citizens from the state government will not necessarily protect taxpayers from having to bail out whatever replaces it.**

Simply declaring that Citizens has become "private" and taking its employees off the state's payroll will not necessarily shield Louisiana taxpayers from the risk of assessments. In fact, it may marginally increase that risk.

Other states have bailed out, levied special taxes, and authorized bond sales to support "private" residual markets. For example, Texas allows its Texas Wind Insurance Association (TWIA) to issue bonds, and Mississippi, following Hurricanes Katrina and Rita, diverted funds from other state purposes to bail out its "private" windstorm association. And state government entities don't always need taxpayer subsidies. The California Earthquake Authority, an earthquake insurer in California that operates as an

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[8] Louisiana Citizens Property Insurance Corporation. "Depopulation Program: Frequently Asked Questions," http://www.lacitizens.com/Static_Content/DepopulationProcess/FREQUENTLY%20ASKED%20QUESTIONS%20-%203-15-09.pdf

[9] Author's calculations based on data from Insurance Information Institute, "Residual Market Property Plans: From Markets of Last Resort to Markets of First Choice," III, September 2009, http://www.docuticker.com/?p=27508

[10] Op. cit., 10.

integral part of state government, has never needed a taxpayer bailout. (That's largely because there have been no major earthquakes since it was created.)

Except through an amendment to the state constitution—something nobody has proposed—the legislature cannot prevent future assemblies from imposing special taxes, diverting state revenues, or otherwise acting to bail out a "private" JUA just as it might bail out Citizens. No state has ever allowed a residual property insurance market to collapse, so it's highly likely that, in one way or another, Louisiana taxpayers would end up on the hook for a JUA's liabilities if a JUA got into trouble.

In one respect, a "private" JUA might prove *more* likely to need a bailout than Citizens. As a private entity, a JUA very likely would have to pay federal income taxes on its yearly "surplus" (profits) and, as a result, would see its reserves available for paying claims increase at a slower rate than Citizens does. If it writes coverage for the same properties and charges the same rates, such an entity will have less capital to pay claims and, if it collapses and needs to be bailed out, it will impose a larger liability on the taxpayers. In short, such an entity would still need monitoring.

Thus a privatization of Louisiana Citizens would have both benefits and risks for the state. When considering efforts to change Citizens' form, the legislature should keep these in mind.

**3. If Citizens is restructured as a JUA or something else, the legislature should carefully monitor the new entity and subject it to some version of state ethics and open government rules.**

A JUA or other entity the legislature creates in place of Citizens would be a "mixed economy" institution. Although "private" in name, such an entity would not face the demands of the market that can prevent private businesses from behaving corruptly. It would be nonprofit, have no stockholders, and, if structured correctly, make no effort to expand its businesses over time—thus such an entity would have little external incentive to manage itself well.

Many practices of the old JUA, indeed, seem questionable in hindsight. According to insurance industry and insurance department insiders, the insurers that ran the old Louisiana JUA often used it as a conduit to do then-legal favors for powerful insurance regulators, such as giving them gifts and taking them on trips. As private-sector workers, moreover, JUA employees could do many things—accept valuable gifts from "clients," protect "trade secrets," engage in certain types of political activity—that Citizens employees might not be able to do today without running afoul of the law.

Even if "private" under the law, a JUA would exist by government fiat. Insurers would be required to participate and, de facto, some consumers would have to buy its products. Thus it should receive much more scrutiny than a private insurer. Although it might not be appropriate to subject a JUA to every restriction currently placed on government

agencies, the legislature would do well to examine exactly how "privatization" of a JUA would change the legal obligations of a market of last resort.

At minimum a new JUA should be required to have an ethics policy substantially similar to that of the state government, open many of its records to public inspection, and post to the Internet a comprehensive audit of its spending.

**4. If it wishes to protect taxpayers from the potential liabilities of a new JUA, the legislature may wish to mandate that the JUA purchase private reinsurance at the "1 in 250 years" catastrophic event level.**

If it wants to minimize the chances that a new JUA will need a bailout, the legislature may want to consider legal mandates requiring it to purchase private reinsurance against catastrophic events. Reinsurance is, in essence, insurance for insurance companies. It allows them to transfer risk from their own capital reserves to those of other companies and their owners. It functions very much like private insurance. When an insurer that has purchased reinsurance experiences losses exceeding a certain level, it makes a claim against its reinsurer and receives a payment.

For taxpayers, reinsurance has many advantages over bond financing or reliance on a bailout: A reinsurance payment doesn't cost taxpayers a penny, never has to be repaid, and doesn't bear interest.

Reinsurance, furthermore, often provides the best means of managing risk over a large pool (the practice at the heart of insurance). While Citizens, by definition, will write policies only in high-risk areas of Louisiana, the purchase of reinsurance would let it diversify risk all over the world. Reinsurers operate globally, so the purchase of reinsurance would let Citizens pool the risk of another major hurricane striking Louisiana with the risk of an earthquake hitting Japan or a major flood damaging the United Kingdom.

Given its diversification and risk management benefits, all sizeable insurers, including Citizens, buy reinsurance sometimes. Among private companies, a desire for efficient management of capital and differing business strategies dictate a wide variety of reinsurance purchase strategies.

A JUA—implicitly backed by state government—may be best off if takes the safest possible route and always purchases a good deal of reinsurance. The highest level of catastrophe reinsurance that's frequently purchased by large private insurers is reinsurance covering "1 in 250" catastrophes—events on the level of Hurricane Katrina—that have a .25 chance of happening during any given year. Having this level of reinsurance would minimize the chances a JUA would ever need a bailout.

If it does this, furthermore, a JUA should make sure to build the cost of the reinsurance into the policies it sells, instead of trying to pass those costs on to taxpayers as a whole or

insisting the state provide it with some sort of taxpayer-financed “backstop.” In some years, including the costs of reinsurance in its policy premiums may make a JUA’s coverage more expensive. In the case of a JUA, however, this may have an advantage in that it would encourage some policyholders to leave the JUA and find private market coverage.

In short, whatever overall approach it takes, it would behoove the legislature to mandate that whatever replaces Citizens purchase a significant amount of private reinsurance.

**Conclusions**

Louisiana’s Streamlining Government Commission’s recommendation to phase out the Louisiana Citizens Property Insurance Corporation deserves careful consideration. State Treasurer John Kennedy deserves credit for bringing Citizens’ ills to public attention and starting a debate over its best possible form.

For the foreseeable future, Louisiana will need some sort of insurer of last resort. Citizens has not done an ideal job and could be improved. Reform could make sense for the state and its residents.

Simply relabeling Citizens as a private entity, however, will not cure the problems it faces or necessarily protect taxpayers from future losses. A new and different structure for Louisiana’s homeowners’ insurance market of last resort deserves consideration.