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Residual Markets

THE TOPIC

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The residual market exists to ensure coverage is available when insurance companies in the regular market reject an applicant as too risky.

In a normal competitive market, insurers are free to select from among people applying for insurance those drivers, property owners, and commercial operations they wish to insure. They do this by evaluating the risks involved through a process called underwriting.

Applicants who are considered "high risk" may have difficulty obtaining insurance through the regular “voluntary” market channels. (The term “high risk” applies to individuals or individual businesses with a poor loss record due to inadequate safety measures; certain kinds of businesses or professions where the nature of the work is hazardous or where the risk of lawsuits is high; and specific locations where the risk of theft, vandalism or severe storm damage is substantial.) To make basic coverage more readily available to everyone who wants or needs insurance, special insurance plans, known as residual, shared or involuntary markets, have been set up by state regulators working with the insurance industry.

Residual market programs are rarely self-sufficient. Where the rates charged to high-risk policyholders are too low to support the program's operation, insurers generally are assessed to make up the difference. These additional costs are typically passed on to all insurance consumers.

The number of drivers and properties insured in the residual market fluctuates as lawmakers and regulators change laws or address availability, rate adequacy and other factors that influence underwriting decisions.

RECENT DEVELOPMENTS

Property Insurance

- **National:** FAIR Plans, the largest of the property insurance pools, have grown both in the number and value of insurance policies written. The number of residential policies increased from 1.90 million in 2004 to 1.93 million in 2005 (the latest data available), which includes policies issued by Florida’s Citizens Property Insurance Corporation, an entity that absorbed both the JUA and Windstorm Plan, see Background. Total exposure to losses — the value of all property insured in the Plans — was $387.8 billion in 2005, slightly less than in 2004. However, in some states in which the FAIR Plan covers coastal property, such as Massachusetts, the residual market expanded. The Massachusetts FAIR Plan grew 24 percent from 2004 and 2005 and, with 13 percent of the market or nearly 200,000 policyholders, it is now the third largest behind Florida and California. Exposure to loss has increased in the Beach and Windstorms Plans, which exist in storm-vulnerable areas of eastern coastal states, rising by 11.6 percent over the same period. Following the 2005 hurricane season, many property insurers began to cut back on their windstorm exposure, further increasing the population of the most hurricane-vulnerable pools, see below.

- **Florida:** If the state legislature meets in special session in December, as expected, Citizens Property Insurance Corporation, is likely to be on the agenda. The state's insurer of last resort which has now become the state's largest insurer following the transfer of some 330,000 policies from the insolvent Poe Insurance Companies, Florida's third-largest insurance group. When Citizens was formed, it was expected to be able to decrease its policy count substantially by offering business to private companies. This year it had expected to shed some 300,000 policies, a goal that it now seems unlikely to meet. Citizens is the only insurer currently writing coverage for mobile homes. There are about 800,000 mobile homes in Florida, according to the latest data from the U.S. Census.

- Legislation enacted in early May 2006 to bolster the state's property insurance market included several measures designed to put Citizens on a firmer financial footing. Among the provisions were the following: Citizens will no longer cover high-value homes -- those with a combined structure and contents replacement value of $1 million or more -- or vacation and second homes of any value, unless they can prove that they have been rejected for coverage by one regular insurance company and three surplus lines companies, specialized insurance companies that assume higher risks than traditional insurers. Surplus lines companies' rates are not regulated. Citizens' rates will no longer be subsidized on a regular basis through assessments that are passed on to all policyholders in the state. Instead, Citizens will charge rates to its high-risk account customers that are high enough to cover claims from a 1-in-100-year hurricane, without having to assess insurers or issue bonds to cover the shortfall, a move that will be phased in over a three-year period and that puts rate adequacy requirements for the pool on the same level as requirements for regular insurance companies.

- Recent rate increases, one to ensure that Citizens' rates exceed those of the top 20 insurers in the market and the other to bring rates up to an actuarially sound level, produced average statewide increases of 16.1 percent for homeowners, 6.7 percent for mobile homes and 21.5 percent for dwelling fire policies, according to Insurance Commissioner Kevin McCarty. In addition to rate increases, Citizens is relying on bond financing. The insurer has completed a $3.05 million bond sale, revenues from which will be used to pay future claims in the event that the insurer's other resources, including reinsurance from the Florida Hurricane Catastrophe Fund, have been exhausted.

- To help solve the growing difficulty of obtaining commercial insurance in high-risk locations, the insurance department has set up a Joint Underwriting Association (JUA) for business owners. The JUA is a state-run pool, which will be able to provide reinsurance also. It will be run by a servicing insurance company. In addition to collecting premiums, the pool will be able to issue bonds and assess insurers for any losses. The law requires rates for policies written by the commercial JUA to be actuarially sound but, unlike requirements for Citizens, commercial policies do not have to be higher than those of the market leaders.

- **Mississippi:** The rate increase for the state's wind pool policy will be less than expected. The governor set aside $50 million in federal aid for rebuilding communities damaged in last year's hurricanes to help the Mississippi Windstorm Underwriting Association, which covers about 15,000 homes and businesses, and the insurance department rejected the pool's request for a 193 percent increase after the receipt of federal funds. Originally, the pool requested a 397.8 percent rate increase for private homes insured for wind and hail damage, a 268.3 percent increase for commercial properties and a 60.4 percent increase for mobile homes, reflecting in part the greatly increased cost of reinsurance — insurance for insurance companies. Now the increase for homeowners will be 90 percent.

- The pool's financial status will be viewed on a monthly basis, officials say. The pool bought $350 million in reinsurance coverage for 2006, double the amount it had carried before, at a cost of $43 million. Part of the $50 million in federal funds— $30 million — would be applied to the reinsurance bill for 2006 and the remainder to the bill for 2007. The association has assessed its member insurance companies $545 million for Hurricane Katrina claims; the amount reflects costs after reinsurance payments. Currently, insurers doing business in Mississippi may not recoup the assessment amount by surcharging their policyholders as they can in other states. Lawmakers will consider changes to the law.

- **North Carolina:** Rates for homeowners insurance in coastal counties are seriously inadequate, according to insurance industry observers. 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. As a result of inadequate rates, insurers have been cutting back on homeowners insurance policies in high-risk areas and the state's FAIR Plan has grown, more than doubling its exposure to loss in only two years. At the end of 2005, it had almost 117,000 policies with an exposure of $41.3 billion, compared with about 69,000 policies and an exposure of $17.8 billion at the end of 2003.

- **South Carolina:** The insurance department is considering expanding the geographic area in which residents are eligible for wind pool coverage.

- **Louisiana:** Louisiana followed Florida's lead and created a Citizens Property Insurance Corporation in 2003. Now lawmakers and state officials would like to ease the burden of surcharges added onto to homeowners and other property insurance policies to pay off Citizens' debts and the cost of a bond issue. Suggestions include using the state's surplus, if the constitution permits, or allocating other monies. State officials announced earlier that policyholders could see a 20 percent homeowners premium surcharge this year, a combination of insurers' passed-on assessments for the debt (an average of 15 percent) and the cost of issuing bonds (5 percent) to pay for additional 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 $850 million in bonds. The pool 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 pull back from risky areas and a law that has prevented companies from dropping customers sunsets. Private insurers have requested significant rate increases in the face of forecasts of above average hurricane activity for at least the next decade. By law, Citizens rates must be at least 10 percent above the private market .

- **Texas:** In Texas the governor has set up a special committee to study windstorm coverage issues, including the way rates are set for coastal counties. The Texas Windstorm Insurance Association's (TWIA) liability, or exposure to loss, is expected to grow to about $50 billion by 2007, according to officials. The TWIA, which was created in 1971 and covers 14 coastal counties and part of Harris County, is in need of additional funding. About 25 percent of the state's population lives along the coast. Increasing development, together with a reduction by some insurers of the number of coastal policies they will issue, is pushing up the pool's policy count and its exposure to loss, already at about $40 billion. In November, the insurance department granted the TWIA a residential rate increase of 4.1 percent, far less than the 20 percent it had requested, and a commercial property increase of 3.7 percent, instead of a 22 percent hike. Both residential and commercial rates were raised earlier this year by single digit amounts. The insurance commissioner said that the increases were the first steps in a multiyear effort to strengthen the financial condition of the pool. The payment of some 11,000 Hurricane Rita claims in 2005 resulted in a deficit and a $100 million assessment on insurance companies. The growing threat of severe hurricanes and higher construction costs suggests that rates should be raised substantially but, by law, rate increases are capped at 10 percent. The pool grew from almost 69,000 policyholders at the end of 2001 to about 160,000 in mid-2006. Almost half of the TWIA's residential properties are in Galveston County.

- To be better prepared financially to face the upcoming hurricane season, the TWIA is recommending 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 half of one percent surcharge would be imposed on all property/casualty insurance policies in the state, with the exception of workers compensation, medical malpractice and health insurance policies, to pay for a postevent bond issue. However, before bonds can be purchased, the legislature must approve of the funding plan. Unless the issue is considered in a special session, the proposal won't be considered until the next regular legislative session which begins in January 2007.

- **Massachusetts:** In Massachusetts the insurance commissioner has granted the state's FAIR Plan a 12.4 percent average rate increase but rates in the Cape and Islands will rise by about 25 percent, due largely to huge increases in the cost of reinsurance. The Plan is also preparing another request for 2007 because the Plan's rates lag behind the regular market. A bill passed in December 2004 gives the insurance commissioner power to adjust the rates of the state's FAIR Plan upward, starting in 2006, so that it does not compete with private insurers, whose rates on the Cape and islands have increased significantly. The Plan is the largest insurer on the Cape with about 43,000 policyholders, about one-third of the market there. A number of small regional insurers, which have more difficulty than larger companies spreading the risk, have announced they will no longer insure properties on the Cape. Some observers believe that if the state's auto insurance system were reformed to attract more national insurers, the homeowners market would also benefit. The Massachusetts FAIR Plan is one of only six that offer coverage almost comparable to a homeowners insurance policy.

Auto Insurance

- Nationally, the residual market's share of total auto insurance premiums dropped 4 percent between 2003 and 2004 to 1.5 percent. Residual market private passenger premiums represented 1.6 percent of the total auto insurance market in 2004 and commercial residual market premiums represented 2.7 percent, according to the latest data from the Automobile Insurance Plans Services Office. This is well below the 1995 figure of 4 percent. In most jurisdictions the percentage was well below one percent.

- **California:** In California the low cost auto insurance plan administered by the state's assigned risk plan was expanded to an additional six counties, starting in April 2006 and could be available in other counties if the commissioner sees a need. The program, which began in Los Angeles and San Francisco in 2000 and now covers more than 10,000 drivers in the two cities, provides basic liability and uninsured motorist coverage and $1,000 in medical care payments to low income drivers with good driving records, see report on Urban Issues.

- **North Carolina:** The state with the highest percentage in the private passenger residual market was North Carolina, at 24 percent, followed by Massachusetts, at 6.5 percent. However, in Massachusetts, about one quarter of all commercial auto insurance premiums ends up in the residual market. In North Carolina, a considerable number of drivers are insured in the residual market because the state's current auto insurance regulatory system does not allow insurers the flexibility to charge a rate that reflects true risk. Those drivers believed to be too risky for the rate allowed are ceded or transferred to the shared market.

- **Massachusetts:** In a unanimous decision, the Massachusetts Supreme Judicial Court handed down a long awaited ruling that gives Insurance Commissioner Julie Bowler the power to revamp the state's residual market plan to create an assigned risk plan. The insurance department is going ahead with the changes but critics say all work on the new program should come to a halt until the Governor-elect has had a chance to study the issue.

- However, reform of the Plan is already at a different stage from when the lawsuit was filed. Starting in March 2006, 171,000 high-risk drivers along with their insurance agents were reassigned to other insurance companies to spread the risk of losses more equally. Critics of the former system said that CAR, a reinsurance facility, see Background, was overly complicated and prone to abuse. Some insurance companies were assigned agents with a high percentage of bad drivers, pushing up claims for those few insurers while others benefited from dealing with agents whose customers were less risky drivers. These inequities resulted in some insurers paying a greater percentage of CAR losses than their market share, a feature of the system largely responsible for the steady exodus of insurers from the state. Only 19 insurance companies still write auto insurance in Massachusetts, compared with 53 in 1990. Sentry Insurance said that it was leaving the state at the end of the year because the outlook for reform was so uncertain. Proponents of the status quo said the change in the distribution system would reduce pressure to overhaul the entire system. Others believe the appeal court's decision will ensure that reform of the auto insurance system is at the top of lawmakers' legislative agenda in 2007.

- In December 2004 the insurance commissioner issued final orders approving the establishment of an assigned risk plan to replace CAR, the organization that now distributes high risk drivers. The Commissioner believes assigned risk plans which exist in 42 other states offer a fairer way of handling claims and of sharing losses generated by the residual market among insurance companies that service the market. In an assigned risk plan new applicants for insurance are allocated to companies based on market share, see Background section. Under the original plan, the assigned risk system was to take effect in 2008, following a three-year transition period. Governor Mitt Romney's introduced a bill that would have completely overhauled the state's auto insurance system but the legislature failed to act on it.

Medical Malpractice

- Where Joint Underwriting Associations (JUAs) exist, they are seeing enrollments surge. Where there is no residual market mechanism, regulators in such states as Montana are setting up a JUA or using other options to provide needed coverage (see Medical Malpractice report)

Workers Compensation

- Positive trends in the workers compensation residual market are continuing. Estimated residual market premiums in 2005 for the pools serviced by the National Council on Compensation Insurance (NCCI) declined to $1.4 billion, a drop of about 7 percent from the previous year, when the premium totaled $1.5 billion. The market's share of the total also decreased, falling to about 11.5 percent of the total for states for which NCCI collects data, compared with 13 percent for 2004.

- Fewer employers, 5 percent fewer nationwide, are now insured in the residual market, according to NCCI figures. The drop was steepest for large employers who have been moving to the voluntary market, partly as a result of revised NCCI pricing and safety incentive programs. The residual market's share of total premiums bottomed out at 3 percent in 1999, or $300 million, but in the early part of the 1990s it was a considerable burden on the voluntary market, which has to pay for the residual market's losses, accounting for more than one quarter of total market premiums. The combined ratio, a measure of profitability, for the workers compensation residual market in 2005 remained the same as in 2004, 113, and has fluctuated by only a few points since 1998.

- **Oklahoma:** In Oklahoma a task force studying the competitiveness of the workers compensation in connection with the state's residual market, CompSource Oklahoma, has raised some issues for the legislature to consider, including the definition of a "carrier of last resort," whether CompSource should be required to meet that definition and the pros and cons of mutualization – changing it into a private insurance company. The State Insurance Fund was created in 1933 and changed its name to CompSource in 2002.

BACKGROUND

Insurance is a mechanism through which individuals and businesses can transfer risk to another entity: an insurance company. Many different programs have been established to assure that insurance is available to individuals and businesses having difficulty obtaining coverage in the "voluntary market," that is the risk that insurers voluntarily assume. The business that insurers do not voluntarily assume is called the residual market. Residual markets may also be called "shared," because the profits and losses of each type of residual market are shared by all insurers in the state selling that type of insurance, or involuntary, because insurers do not choose to underwrite the business, in contrast to the regular voluntary market.

The Automobile Residual Market: The first of the residual market mechanisms for automobile coverage was established in New Hampshire in 1938. As states began to pass laws requiring drivers to furnish proof of insurance, having auto liability insurance became a prerequisite for driving a car. Today, all 50 states and the District of Columbia use one of four systems to guarantee that auto insurance is available to those who need it. All four systems are commonly known as assigned risk plans, although the term technically applies only to the first type of plan, where each insurer is required to assume its share of residual market policyholders or "risks." (The term "risk" is used in the insurance industry to denote the policyholder or property insured as well as the chance of loss.) Commercial auto insurance is also available through the residual market.

1) Automobile Insurance Plans — The assigned risk plan, the most common type, currently found in 42 states and the District of Columbia, generally is administered through an office created or supported by the state and governed by a board representing insurance companies licensed in the state.

When agents or company representatives are unable to obtain auto insurance for an applicant in the voluntary market they submit the application to the assigned risk plan office. These applications are distributed randomly by the automobile insurance plan to all insurance companies that offer automobile liability coverage in the state in proportion to the amount of their voluntary business. Thus, if on a given day the plan receives 100 applications from agents around the state, a company with 10 percent of that state's regular private passenger automobile insurance business will be assigned 10 of those applicants and will be responsible for all associated losses.

Generally, each insurer services the policyholders assigned to it just as it would the policyholders it insures in the voluntary market. However, there are exceptions. For example, the state of Rhode Island set up a service center to carry out all administrative and service functions, except handling claims. In some jurisdictions, companies that prefer not to service the policies of policyholders assigned to them can make arrangements to have them serviced by others, either the Plan or in some states “servicing companies,” insurers that service other companies’ business as well as their own.

Some states have modified the basic automobile insurance plan to limit the number of insurance companies servicing assigned risk policyholders. Limited service arrangements are also typical of the programs designed to respond to the commercial auto residual market, especially large commercial accounts such as taxis and corporate-owned fleets.

Assigned risk policies usually are more restricted in the coverage they can provide and have lower limits than voluntary market policies. In addition, premiums for assigned risk policies usually are significantly higher, although not always sufficiently high to cover the increased costs of insuring high-risk drivers.

2) Joint Underwriting Associations (JUAs) — Automobile JUAs, found in four states, Florida, Hawaii, Michigan and Missouri, are state-mandated pooling mechanisms through which all companies doing business in the state share the premiums of business outside the voluntary market as well as the profits or losses and expenses incurred. To simplify the policyholder distribution process, insurance agents and company representatives are generally assigned one of several servicing carriers (companies that have agreed for a fee to issue and service JUA policies). They submit applications to that company, which then issues the JUA policy. Coverages offered by JUAs generally are the same as those offered in the voluntary market but the limits may be lower. Although rates may be higher than in the voluntary market, they may not be sufficient for the JUA to be self-sustaining. State statutes setting up the JUA generally permit it to recoup losses by surcharging policyholders or deducting losses from state premium taxes. (JUAs may be set up for other lines of insurance, including homeowners insurance. JUAs for commercial insurance coverage, such as medical malpractice and liquor liability, may operate somewhat differently in some states, see below.)

3) Reinsurance Facilities — Reinsurance facilities exist in North Carolina, New Hampshire and Massachusetts. (In Massachusetts, the current reinsurance facility is known as Commonwealth Automobile Insurers, or CAR). An automobile reinsurance facility is an unincorporated, nonprofit entity, through which auto insurers provide coverage and service claims. After issuing a policy, an insurer decides whether to handle the policy as part of its regular “voluntary business” or transfer it to the reinsurance facility or pool. An insurer is permitted to transfer or “cede” to the pool a percentage of its policies. Premiums for this portion of business are sent to the pool and companies bill the pool for claims payments and expenses. Profits or losses are shared by all auto insurers licensed in the state.

4) State Funds — Maryland established a state-funded residual market mechanism in 1973. Private insurers do not participate directly in the Maryland Automobile Insurance Fund (MAIF), but are required by law to subsidize any losses from the operation, with the cost being charged back against their own policyholders. In years that the fund has a loss, all Maryland insured drivers, including MAIF drivers, help offset the deficit through an assessment mechanism.

Together, residual market programs insured about 2.66 million cars in 2004, the latest data available, about 1.5 percent of the total market, according to the Automobile Insurance Plans Service Office which tracks such data. In 1990, the residual market served 6.3 percent of the total market. In 2004, in a major change from much of the 1990s, only one state, North Carolina, had more than million cars insured through the residual market. At 1.6 million, the pool insured more than 24 percent of the state's total insured vehicles. In South Carolina, which enacted sweeping reforms in 1998, the residual market dropped from 38 percent of all insured cars in 1996 to 0.00 percent in 2004.

The North Carolina residual auto insurance market is unusual in that the laws governing the North Carolina Reinsurance Facility, the state’s auto insurance residual market pool, have produced a complex system of subsidies that keeps the pool’s population high. Drivers with traffic violation points on their record and inexperienced drivers in the pool do pay higher rates, but some of those in the pool because of some lesser risk pay the same as the highest rate charged good drivers. All rates are highly regulated.

Voluntary market rates in North Carolina are kept low. As a result, auto insurers send business that is not expected to be profitable to the pool and the pool loses money each year. This shortfall is offset by surcharges incorporated into premiums, spreading the loss across all drivers. Supporters of the system say the subsidy system makes it easier for more people to buy insurance — North Carolina is among the states with the lowest percentage of uninsured drivers. Critics say that good drivers should not have to pay more so that others can get a good deal.

Other states have seen their residual market fluctuate, depending on conditions in the voluntary market such as the regulatory environment and rate adequacy. For example, in 1987, close to 1.8 million drivers were insured in the New Jersey shared market compared with about 97,300 in 1993. But gradually, this number crept up again as insurers began to withdraw from the state because of the overly harsh regulatory system. Market reforms passed in New Jersey in recent years have brought more auto insurance companies into the market, increasing competition and reducing the need for drivers to seek coverage in the residual market. A 2004 study of residual markets by the Property Casualty Insurers Association of America found that in states where competition is the primary regulator of price, the residual market tends to be small.

JUAs for Other Lines of Insuranc: JUAs are not limited to automobile insurance. More than 10 states now have JUAs for medical malpractice, a line beset by high losses in the 1970s and again in the mid-1980s and once again in the past few years. As happened in the early part of this decade, in a number of states rising costs forced several insurers to leave the medical malpractice marketplace, which in turn diminished the amount of medical malpractice coverage available. In the 1990s, the market for medical malpractice insurance softened, as in other commercial sectors, and several JUAs were dissolved. In this recent crisis, the number increased (see Medical Malpractice paper).

In most states, medical malpractice JUAs operate in a fashion similar to JUAs for automobile insurance, through servicing insurers. In several states, however, the medical malpractice JUA serves as an insurance company, collecting premiums, issuing policies in the name of the JUA and adjusting losses. So that the assessments are spread over as broad a base as possible, each company participating in the JUA is assessed its share of losses, generally in proportion to the company's share of the liability market, which may include personal and commercial automobile liability, general and professional liability and, in some states, workers compensation as well.

In many states, the insurance commissioner has been given standby authority to set up a JUA whenever marketplace conditions require such a move. When it became obvious that insurance was becoming more difficult to obtain in parts of Florida following the disastrous hurricane seasons of 2004 and 2005, the state set up a statewide commercial JUA to provide commercial property insurance.

Market Assistance Plans (MAPs): A MAP is a temporary, voluntary clearinghouse and referral system designed to put people looking for insurance in touch with insurance companies. They are organized when something happens to cause insurance companies to cut back on the amount of insurance they are willing to provide. MAPs are generally administered by agents' associations, which assign insurance applications to a group of insurers doing business in a state. These companies have agreed to take their share of applicants on a rotating basis. In the mid-1980s, MAPs were set up for liability insurance. At that time, some businesses like ski resorts and bars, as well as municipalities, were having trouble finding liability insurance because of the increase in lawsuits filed against them.

Increasingly, MAPs are being created to deal with property insurance problems. In New Jersey, for example, where insurers are concerned about potential storm losses, the insurance department established a MAP in the 1990s. Insurers representing 70 percent of the state's homeowners insurance market participate. Some 20,000 residents in 92 ZIP codes are eligible to apply to the plan for coverage. MAPs can operate alongside JUAs.

When the liability insurance market eventually adjusted, liability insurance became readily available once again and the MAPs were dismantled. MAPs may be organized for a single line of insurance, such as day-care liability, homeowners, or for a broad range of liability coverage. Recently, homeowners insurance MAPs have been formed in several East Coast states and in Texas and medical malpractice MAPs have been created in states such as Washington, where the medical community has had difficulty finding malpractice insurance.

Pools — FAIR Plans, Beach and Windstorm Plans, Workers Compensation Assigned Risk and Others: A pool is an organization of insurers or reinsurers through which particular types of insurance coverage are provided. The pool acts as a single insuring entity, as opposed to some JUAs and assigned risk plans where the policyholder deals directly with an individual insurance company. Premiums, losses and expenses are shared among pool members in agreed-upon amounts. The range of activities handled by the pool varies. Some pool operations are limited to redistributing premiums and losses, while others have broader functions similar to an insurance company. Some pools use specific insurers as servicing carriers.

In pools composed of primary companies (as opposed to reinsurers), business is placed directly with the pool by the agent. (In a reinsurance pool, a member company underwrites the risk, issues the policy and reinsures the business in the pool, see below.) Pools may be mandated by state legislation or established on a voluntary basis.

Among the best-known primary pooling arrangements are property insurance plans which assure that insurance is available to property owners in high-risk, generally urban areas and to owners of properties vulnerable to severe storm damage.

History of Property Pools: The first urban area plan, a forerunner of FAIR Plans, see below, went into effect in 1960 in Boston. Following a spate of fires in some inner city neighborhoods, insurers began to withdraw from these communities, making it difficult for some Boston residents to obtain fire insurance. The Massachusetts legislature drafted a bill that called for a state-operated assigned risk plan for fire insurance. Insurers were against the proposal, pointing out that an assigned risk plan for auto liability insurance has a very different goal from the proposed property insurance plan. Assigned risk plans in auto insurance were established to protect third parties from having no financial recourse if they were struck by a car driven by a driver who had been refused coverage in the voluntary market. A fire insurance assigned risk plan would enable the owner of a property which had been rejected for coverage to buy insurance to protect his own assets.

The industry set out to find a better way to make coverage available, pledging that no property would be denied insurance unless it was inspected and found uninsurable. Where property was deemed in too poor a condition to insure, owners were told what to do to bring it up to insurable standards. A special fire hazard inspection office was established and charged with carrying out the program which became known as the Boston Plan. Fire losses in these neighborhoods subsequently declined and insurance became more readily available. The success of the Boston Plan led to similar programs in other cities and by 1967 there were 10 urban plans.

In 1967, riots broke out in many cities across the nation. As property insurers withdrew from inner city neighborhoods, citing huge losses, insurance departments and insurance industry leaders were called upon to expand existing urban plans and create new ones which eventually led to the establishment of FAIR Plans.

Beach and Windstorm plans had a different genesis. Just as Hurricane Katrina drew attention in 2005 to the weaknesses of the federal government’s flood insurance program and to the private insurance industry’s exposure to loss along the coastline of the Gulf and Atlantic states in what appears to be a new period of increased hurricane activity, so Hurricanes Camille (1969) and Celia (1970) drew attention to the industry’s exposure thirty five years ago. This led to pooling arrangements in coastal sections of seven southern states. Four of these states provide coverage for wind and hail damage only, hence the term Beach and Windstorm Plans.

FAIR Plans: As of September 2006, 32 states and the District of Columbia had property insurance plans known as FAIR, an acronym for Fair Access to Insurance Requirements Plans. The concept of FAIR Plans was established following passage by Congress of the Housing and Urban Development Act of 1968, a measure designed to address the conditions that led to the 1967 urban riots. This legislation made federal riot reinsurance available to those states that instituted such property insurance pools. One of the plans, Arkansas' Rural Risk Plan, was created in 1988 to provide a market for property insurance in rural areas where fire protection is poor or nonexistent. Mississippi's Rural Plan which offered fire, extended coverage and vandalism, see below, was expanded to cover the entire state in 2003. The state's windstorm pool offers wind and hail coverage in coastal counties to the Plan's policyholders. Georgia's FAIR Plan also provides windstorm and hail coverage in coastal counties. Plans in Massachusetts, New York and New Jersey also offer coverage for properties in coastal communities. In most states where FAIR Plans are in operation, they are mandatory, see above for a list of jurisdictions.

Originally, most Plans provided protection only for "perils" outlined in the federal statute: fire, extended coverage (which includes windstorm and hail damage) and vandalism and malicious mischief. Coverage for fire is available as a "stand-alone" policy. Almost half the Plans now offer some form of homeowners insurance policy – homeowners insurance always includes liability coverage — either an all-risk policy (HO-3) or a policy with more restricted coverage. In New Jersey insurers can now use "wraparound" policies to turn FAIR Plan policies, which provide limited coverage, into typical homeowners policies. Some FAIR Plans also offer commercial package policies and some miscellaneous optional coverages such as crime, earthquake and sprinkler leakage. But while broader coverage responds to homeowners needs in one respect, it also pushes up the cost of coverage.

In theory, rates for FAIR Plan coverage were to be set at break-even level. In practice, in most states, there is a subsidy so that rates are lower than they would be in the voluntary market for the same level of risk. FAIR Plans, like many other residual market programs, historically have lost money over the long term, although in a specific year they may be profitable. To cover losses, FAIR Plan members are assessed according to their share of the voluntary property market. Losses are then passed onto policyholders in the plan in the form of higher rates and in some states to policyholders in the voluntary market as well. Some states prohibit the consideration of residual market results when setting rates in the voluntary market. A number of states allow insurers to recoup losses through rate surcharges, which are itemized on a policyholder's premium bill.

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.

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.

Beach and Windstorm Insurance Plans: Counterparts to the FAIR Plans are Beach and Windstorm Insurance Plans, operated by property insurers in states along the Atlantic and Gulf Coasts to assure that insurance is available for both residences and commercial properties against damage from hurricanes and other windstorms. In 2001 there were seven pools, but Florida's windstorm pool merged with the joint underwriting association in 2002 to create a new type of residual market entity, see below. In a similar move in 2003, Louisiana merged its FAIR Plan with its coastal pool in 2003. The Plans are mandatory in all of these states with the exception of Alabama.

(In addition, hail and windstorm coverage for homes in coastal counties is available through a FAIR Plan in Georgia and a WindMap in New Jersey and through the New York Property Insurance Underwriting Association.) Windstorm Plans in Mississippi, South Carolina and Texas offer only wind and hail coverage. Plans in Alabama and North Carolina offer coverage for fire as well.

Established between 1969 and 1971, Beach and Windstorm Plans operate in a manner similar to FAIR Plans, except that properties must be located in a designated area to be eligible for insurance under the Plans.

To encourage insurers to offer coverage on a voluntary basis to properties in Beach and Windstorm Plan areas, these Plans allow for a company to "buy out" of the Plan by providing insurance in the pool area equal to its share of the voluntary market. In Texas, however, buyouts are limited to 80 percent of a company's share in the Windstorm Plan market, so that some of the potential burden of insuring the least desirable risks is spread over all companies offering property insurance in the state.

Property owners who live in areas covered by Beach and Windstorm Plans may be insured for windstorm losses by the Plan or by an individual insurance company. If an insurer has accepted all the windstorm risk it is prepared to assume, an applicant for homeowners insurance may purchase a policy that excludes windstorm coverage from the homeowner's insurance company and pay a separate premium for windstorm coverage to the Plan. In the states whose Beach Plans offer fire coverage, a policyholder may purchase a basic fire policy from the Plan, or in some states a homeowner's policy that offers more comprehensive protection, including liability coverages. Where there is flood damage and the policyholder is insured through the federal government's National Flood Insurance Program, the policyholder's homeowners insurance broker or agent generally coordinates the claim settlement process. The value of coastal property in the states with Beach and Windstorm Plans has soared over the past decade, more than doubling between 1996 and 2001, alone. In 2004 the Plans exposure to loss totaled $30.04 billion, a jump of 13.7 percent over the previous year, as the cost of rebuilding and the number of policies issued by the Plans increased.

One disadvantage of Beach and Windstorm Plans, and the National Flood Insurance Program, is that the availability of insurance encourages development of coastal areas where construction otherwise would not be feasible and where tax money must be spent to protect against continuous erosion to preserve the property, see also Catastrophes report.

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 the 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 compare the number of properties insured under any Plan with numbers from earlier years. FAIR Plans have almost doubled in size, pushed up in large part by these mergers, and the increase in coastal properties in such states as New York and Massachusetts, but also by more stringent underwriting standards on the part of insurers in the voluntary market.

Residual Market Plan Mergers: The first state to decide that one entity should run its residual property insurance market was Florida. In 2002 the state’s two residual market organizations, the

JUA and the Florida Windstorm Underwriting Association, merged to become the Citizens' Property Insurance Corporation (CPIC). The JUA was established by the Florida legislature in 1992, following Hurricane Andrew, to provide homeowners insurance to those unable to find coverage in the voluntary market. The Florida Windstorm Underwriting Association (FWUA) was formed in 1970. (Homeowners continued to purchase fire, theft and other homeowners coverages from a regular insurance company.) Over its more than 30 years of operation, the windstorm pool grew, in geographical size as well as in the number of property owners it insured. Windstorm coverage is now available from the pool for part or all of 29 of Florida's 35 coastal counties.

The Florida CPIC has a tax-exempt status. This feature enables it to finance loss payments in the event of a major disaster by issuing tax-exempt bonds that carry low interest rates, thus reducing financing costs over the years by hundreds of millions of dollars.

The enabling legislation required that the CPIC reduce its probable maximum loss, the greatest loss it is expected to sustain, by 25 percent by February 2007 and by 50 percent in 2012. For this to happen, Citizens has to shrink rather than grow. Recent legislation that limits the number and size of policies written by Citizens will soon take effect. More insurers are likely to be attracted to the marketplace as a result of higher premiums and laws providing greater flexibility to change rates. And stronger building codes and the increasing popularity of so-called “fortified homes” are making more homes less susceptible to damage by high winds.

In an effort to reduce its potential exposure to loss, Citizens offers policyholders financial incentives to invest in hurricane-resistant home improvements. Premium discounts range from 3 percent for roof gable and garage door bracing to as much as 18 percent for improvements that reduce the likelihood of materials such as glass shattering when hit with flying debris.

At one time, rates for wind risk were based on factors associated with fire and other hazards, as if the coverage were part of a regular homeowners policy. To rate wind risk more accurately, the Florida windstorm pool reclassified each home based on risk of wind damage, applying premium credits for features that decreased the likelihood of damage, such as shutters, and surcharges for those that increased it. For example, two-story structures are more vulnerable to damage than one-story dwellings. CPIC rates are based on the revised classification.

In Louisiana, following Florida’s model, the FAIR Plan and the Coastal Plan became the Louisiana Citizens Property Insurance Corporation in 2004. The enabling legislation requires the new plan’s rates to be actuarially sound and to be 10 percent higher than average rates charged in the voluntary market to ensure that it is truly a market of last resort. In addition, the measure sets up a system to set aside funds taxfree for catastrophes and allows insurers to recoup losses incurred by the Plan from all property insurance policyholders in the state. Lack of a recoupment process is one reason why so many insurers had withdrawn from the state, leaving it with only 20 companies competing for homeowners insurance business before the law was revamped.

Workers Compensation Assigned Risk Plans and Pools: The mechanism used to handle the residual market varies from state to state. In the six states with a monopolistic state workers compensation fund, all businesses are insured through that fund. In most states with a competitive state fund (an entity that competes for business with private insurers), the fund accepts all risks rejected by the voluntary market, thus eliminating the need for assigned risk plans. In states without a competitive fund, insurers may be assigned applicants based on their market share and service those employers as they would employers that came to them through the voluntary market, through a system known as direct assignment. They may also participate in the residual market through a reinsurance pooling arrangement.

In most states, between 80 and 90 percent of residual market plan business is assigned to the pool. In a few states the pool is the only option. The pool hires servicing companies, generally insurers, which receive a fee to issue policies and settle claims. All insurers doing business in the state, that elect to participate in the pool rather than direct assignment share in the profits and losses in accordance with their share of the state's workers compensation market. In some states, the assigned risk plan is administered by the National Council on Compensation Insurance, which also administers the largest of the pooling arrangements, the National Workers Compensation Pool (NWCP). The term "national" is a misnomer. The NWCP shares some administrative functions across state lines but operates a separate pool in each of the states for which it is responsible.

There are also other mechanisms for dealing with the residual market. Florida, for example, established a JUA to serve the workers compensation residual market. Unlike assigned risk plans where insurers subsidize the plan, JUAs are supported by assessments on self-insured employers and employer groups as well as traditional insurers. Minnesota is an exception to the competitive fund rule. The state has a competitive fund but also has an assigned risk plan. The competitive fund is assessed, based on its market share, like any other workers compensation insurer doing business in the state. Several other states have residual market programs in which the state fund shares in the financial results.

Before a firm can be offered workers compensation coverage through the assigned risk plan, in most states the applicant must have been rejected in the voluntary market by two insurers. The firm's application for coverage is sent directly to the plan's administrator, which either assigns the business to one of the direct assignment insurers or insures it in the pool.

Workers Compensation Second Injury Funds: Second injury funds were created to encourage businesses to hire workers who are physically handicapped by congenital defects or the residual effects of an accident or illness but due to other laws that now protect the physically handicapped worker, such as the Americans With Disabilities Act, some states are disbanding their fund.

Second injury funds have played an important societal role. Before the protection afforded by the American Disabilities Act such workers might have had difficulty finding jobs because if they were injured in the workplace, the employer would have been liable for compensation for the total disability, not just the work-related injury. Where second injury funds still exist, in most states, if a person already handicapped in some way suffers an injury, the current employer's insurance company pays only the benefits associated with that workplace injury. The second injury fund pays the difference between the workplace injury benefits and those that the worker would receive for the total disablement — the initial handicap combined with the subsequent injury on the job. The funds operate on a pay-as-you-go basis instead of establishing reserves for liabilities anticipated as a result of claims that have been transferred to them.

Initially, second injury funds were limited to cases where the combined injury resulted in permanent and total disability. In addition, to be compensated, an employer had to prove that he or she was aware of the worker's preexisting condition at the time that person was hired. However, many states relaxed these rules. As a result of this broadened eligibility, fund obligations in some states grew dramatically and some accrued substantial unfunded liabilities.

Following the passage of the federal Americans with Disabilities Act, which provides protection for disabled workers similar to second injury funds, states began reassessing the need for such funds and many passed legislation abolishing their second injury funds. Second injury funds receive money from insurance companies and employers as well as from legislative appropriations. Insurance company payments may be based on a percentage of total compensation paid, premiums collected or the nature of the specific injury. The second injury funds may be administered by the state Workers Compensation Commission, Industrial Board or Department of Labor.

Nuclear Energy and Other Voluntary Pools: The use of nuclear fission for peaceful purposes brought with it a demand for limits of liability insurance significantly higher than individual companies alone were able to provide. The nuclear energy pools were voluntarily organized by the insurance industry, in response to this demand. There are three nuclear energy pools in the United States today that provide liability and property damage coverage for nuclear reactors and fabricators and transporters of reactor fuels. Each pool issues identical policies and reinsures its business with the other two pool members. In addition, the pools purchase reinsurance from Lloyd's and other alien (not domiciled in the United States) insurers. Policies are issued in the name of the pool, showing each member company's participation.

Reinsurance Pools: There are two basic types of reinsurance pools. In the first, an individual member company underwrites the risks and issues the policy to the policyholder. The member then automatically reinsures the risk with the pool in accordance with the pooling agreement. In the second type, the pool functions as a general reinsurer, underwriting reinsurance policies for primary companies, regardless of whether they are members of the pool. Examples of reinsurance pools include the Registered Mail Insurance Association, which covers currency, securities and other valuables transported by registered and first-class mail, and shippers of property transported by armored cars; and the Excess Bond Reinsurance Association, which offers fidelity coverage (protection against employee fraud) to commercial banks.

State Funds and Other Pooling Arrangement: Unsatisfied Judgment Funds exist in three states, Michigan, New York and North Dakota, to compensate victims of auto accidents (with the exception of uninsured vehicle owners) who cannot collect the damages awarded them, generally because the defendant had no insurance or assets with which to pay the judgment.

Unsatisfied Judgment Funds are administered differently, depending on the state. In two states, Michigan and South Dakota, they are administered by the state and in New York by insurers alone. New Jersey began to phase out its fund in 2003. Like residual markets, these funds are partially subsidized or totally paid for through assessments against insurance companies. To be eligible for state funds, accident victims must be residents of the state and have been injured in an accident that occurred within state boundaries. Out-of-state residents usually are eligible if their home state provides a similar program. There are few standard provisions. Each state has its own set of rules which determine deductibles, maximum compensation available, minimum size of losses covered, coverage for property damage and so on.

Pools are being set up by states to insure medically high-risk individuals who often have difficulty obtaining health insurance in the voluntary market. Most are similar to JUAs and FAIR Plans in that they assess insurance companies for claims costs in excess of the premiums collected. Most set premiums at a level that is lower than the price these individuals would have to pay if they could obtain health insurance through normal channels.

INSURANCE PROVIDED BY FAIR PLANS BY STATE, 2005 (1)

State	Habitational policies	Commer-cial policies	Exposure (2) ($000)	State	Habitational policies	Commer-cial 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	**Total**	**1,484,069**	**101,037**	**331,527,008**

(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 (PIPSO).