The Florida Senate

PROFESSIONAL STAFF ANALYSIS AND ECONOMIC IMPACT STATEMENT

(This document is based on the provisions contained in the legislation as of the latest date listed below.)

Prepared By: Finance and Tax Committee

BILL: SB 2562

INTRODUCER: Senator Ring

SUBJECT: Capital Investment/Hurricane Catastrophe/SBA

DATE: April 10, 2007 REVISED:

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	Peacock	Deffenbaugh	BI	**Favorable**
2.	Keating	Johansen	FT	**Pre-meeting**
3.			GA	
4.				
5.				
6.				

I. Summary:

Senate Bill 2562 directs the State Board of Administration to conduct a study on providing or participating in capital investment options for hurricane catastrophe-related losses and to report its findings to the President of the Senate and the Speaker of the House of Representatives. The bill appropriates $350,000 from the General Revenue Fund for this purpose.

This bill creates an undesignated section of the Florida Statutes.

II. Present Situation:

State Board of Administration (SBA)

The SBA, a constitutional entity of Florida state government, manages 27 investment funds with over $150 billion in assets under management as of June 30, 2006. The SBA manages the fourth largest pool of public pension fund assets in the country and ninth largest in the world. The SBA has a long history of utilizing prudent and diversified investment strategies in domestic equities, foreign and global equities, fixed income, private equity, and real estate.

The SBA is also responsible for management of the Florida Hurricane Catastrophe Fund (FHCF). This fund was created in 1993 in response to Florida's property insurance crisis resulting from Hurricane Andrew. The FHCF provides a stable and ongoing source of reimbursement to insurers for a portion of their catastrophic hurricane losses in order to provide additional insurance capacity in the state and stabilize insurance rates.[1]

[1] State Board of Administration (Florida), available at: http://www.sbafla.com/

Florida Hurricane Catastrophe Fund; Expansion of Coverage under HB 1-A

Reinsurance coverage purchased through the FHCF is mandatory for all residential property insurers. House Bill 1A, enacted during the 2007 Special Session A, significantly expanded coverage under the FHCF as an option to insurers. The act allows residential property insurers to purchase additional coverage above the maximum limits of the mandatory FHCF coverage, referred to as Temporary Increase in Coverage Limit options ("TICL"), for the 2007, 2008, and 2009 contract years. The TICL options allow an insurer to purchase additional reinsurance for its share of up to $12 billion, in $1 billion increments, above the mandatory FHCF annual limit of $16 billion estimated for 2007 (i.e., up to a total of $28 billion). This act allows the SBA to further increase the limits by an additional $4 billion (i.e., up to $32 billion). The TICL coverage reimburses the insurer for 90 percent, 75 percent, or 45 percent of the insurer's losses above its retention, at the same percentage selected by the insurer for its mandatory FHCF coverage. Insurers are required to pay a premium established by the SBA under the same method for determining "actuarially indicated" premiums for the mandatory FHCF coverage, which generally establishes a premium equal to the estimated average annual loss for the coverage purchased. Based on current loss models, this is expected to be a premium equal to about 3 percent of the coverage amount (commonly referred to as a 3 percent "rate-on-line.") These premiums are significantly lower than charged by private reinsures and are the primary sources of premium savings under this act.

Each insurer that buys FHCF coverage is subject to a "retention," similar to a deductible, which is the amount of hurricane losses the insurer must pay before such losses are reimbursed. Another optional coverage under the act is coverage below each insurer's mandatory FHCF retention, referred to as Temporary Emergency Additional Coverage Options ("TEACO"), for the 2007, 2008, and 2009 contract years. The TEACO options allow an insurer to select its share of a retention level of $3 billion, $4 billion, or $5 billion, to cover 90 percent, 75 percent, or 45 percent of its losses up to the normal retention for the mandatory FHCF coverage, estimated to be about $6 billion in 2007. The TEACO coverage applies to two hurricanes for each contract year. The TEACO premiums established by the act are priced at near-market levels which assure availability of reinsurance coverage but are not expected to generate premium savings for most insurers. The relatively high premiums also serve to significantly reduce the risk to the state for the TEACO coverage.

The third additional coverage option, authorized by the act, allows eligible residential property insurers to purchase up to $10 million in additional FHCF coverage at a level significantly below the mandatory FHCF retention and likely to be lower than the lowest retention ($3 billion) under the TEACO options. The act makes this coverage available to "limited apportionment companies" generally defined as insurers with a surplus (net worth) of $20 million or less that participated in a similar program in 2006, limited apportionment companies that began writing property insurance in 2007, and insurers approved to participate in either 2006 or 2007 for the Insurance Capital Build-Up Incentive Program pursuant to s. 215.5595, F.S.

The act also authorized the SBA to purchase capital market instruments to cover FHCF obligations, similar to the previous authority it had to purchase reinsurance.[2]

[2] 2007-A Special Session – Summary of Legislation Passed, available at: http://www.flsenate.gov/Publications/2007A/Senate/reports/summaries/pdf/sessum07A.pdf

If the cash balance of the FHCF is not sufficient to cover losses, the law allows the issuance of revenue bonds, which are funded by emergency assessments on all property and casualty policyholders, including surplus lines policies, other than workers' compensation, flood, and accident and health insurance. Annual assessments are capped at 6 percent of premium with respect to losses from any 1 year and a maximum of 10 percent of premium to fund hurricane losses from multiple years. The estimated cash balance available for the 2007 hurricane season will be approximately $2.0 billion, plus amounts paid by insurers for the optional coverages available. Due to obligations of the FHCF following the 2004 and 2005 hurricanes, the SBA issued a $1.35 billion bond to pay claims and a $2.8 billion bond to provide cash liquidity for the 2006 hurricane season. The $1.35 billion bond issue is funded by about a 1 percent assessment for 6 years on property and casualty insurance policies, beginning January 1, 2007. The $2.8 billion bond issue for liquidity is being funded by investment income from the bond proceeds themselves (since the proceeds are not yet needed to pay claims).

Previous SBA Study on Private Capital Investment Options

On August 30, 2006, the Executive Director of the SBA was asked by Governor Bush to conduct a study of viable sources of private capital and how to increase the flow of private capital into Florida's residential property insurance market.

In research of the potential for new capital market products to create capacity, the SBA's report found that because traditional reinsurance accounts for 85 percent of catastrophe risk protection, the capital markets are unlikely to rapidly resolve the pricing/capacity crunch facing Florida insurance markets in the short-term. Nonetheless, the report cited that investors responded quickly to the scarcity of capital in 2005 and helped to keep reinsurance rates from rising even more. If capacity were to remain in short supply, insurance-related capital market products would become more widely utilized.

The study found that increasing adoption of insurance-related capital market products have great potential to transfer catastrophe risk to "non traditional" investors and free up balance sheet capacity for reinsurers and insurance companies to write more policies. The products cited in this report as most likely to be viable included industry loss warranties, catastrophe bonds, sidecars, and catastrophe risk exchange-traded contracts.[3]

III. Effect of Proposed Changes:

Section 1 provides that on or before January 15, 2008, the SBA shall submit a Hurricane Catastrophe Fund Exchange Report to the President of the Senate and the Speaker of the House of Representatives. The report shall include findings and recommendations on whether and how the state might provide, use, or promote the use of capital market risk transfers vehicles for hurricane catastrophe losses. These could include exchange-traded and other financial products. The report shall assess such vehicles in the context of an expanding market place for risk transfer and the state's interest in maintaining a viable private-sector market for property insurance and creating additional insurance capacity in the state. The bill allows for the SBA to confer with

[3] A Study of Private Capital Investment Options and Capital Formation Impacting Florida's Residential Insurance Market, SBA, September 19, 2006.

other state agencies, state universities, and other public or private entities while preparing the report. The bill allows the board to hire consultants as necessary to assist in researching and developing the report.

Section 2 states that the sum of $350,000 in non-recurring funds will be appropriated from the General Revenue Fund to pay the costs of preparing the Hurricane Catastrophe Fund Exchange Report as described above in section 1. All costs and fees incurred by the board in preparing the report shall be paid from funds appropriated in this section.

Section 3 provides that this act shall take effect July 1, 2007.

IV. Constitutional Issues:

A. Municipality/County Mandates Restrictions:

None.

B. Public Records/Open Meetings Issues:

None.

C. Trust Funds Restrictions:

None.

V. Economic Impact and Fiscal Note:

A. Tax/Fee Issues:

None.

B. Private Sector Impact:

None.

C. Government Sector Impact:

The sum of $350,000 in non-recurring funds would be appropriated from the General Revenue Fund to the SBA to pay the costs of preparing the Hurricane Catastrophe Fund Exchange Report.

VI. Technical Deficiencies:

None.

VII. Related Issues:

None.

VIII. Summary of Amendments:

None.