HOUSE OF REPRESENTATIVES STAFF ANALYSIS

BILL #: HB 3A CS Hurricane Preparedness and Insurance
SPONSOR(S): Kravitz and others
TIED BILLS: **IDEN./SIM. BILLS:**

REFERENCE	ACTION	ANALYST	STAFF DIRECTOR
1) Jobs & Entrepreneurship Council	15 Y, 0 N, w/CS	Callaway	Thorn
2) Policy & Budget Council		Martin	Hansen
3)			
4)			
5)			

SUMMARY ANALYSIS

The bill makes the following changes to the Florida Hurricane Catastrophe Fund (CAT Fund, FHCF, or fund):

- For two years, the bill allows insurers to purchase additional coverage from the CAT Fund at a rate lower than the private reinsurance rate for lower retention levels (TEACO) and for higher capacity levels (TICL). Insurers are able to lower their retention level by a maximum of $4 billion in $1 billion increments. Insurers are able to increase their capacity level by a maximum of $4 billion in $1 billion increments. For the 2007-2008 contract year, under this plan, the FHCF coverage will be provided as low as $2 billion and as high as $20 billion.

  - If an insurer elects to purchase CAT Fund coverage at the lower retention level and/or at the higher capacity level, the insurers must pass through 100 percent of the savings they receive from their purchase to consumers. In no case may an insurance company provide less than a 25 percent reduction in premiums for its purchase of CAT Fund coverage at a lower retention level and/or higher capacity level, unless it applies for and receives a waiver from the Financial Services Commission.

  - After the 2-year period, the CAT Fund retention and capacity would be governed by statutory formula, but the State Board of Administration (SBA) would be empowered to reset the retention level and capacity with the approval of the Legislative Budget Commission (LBC). Although the TEACO rate/price is set by statute, the SBA is authorized to amend this rate/price with the approval of the LBC.

- Suspends the rapid cash buildup factor in the CAT Fund, which requires insurers to add a factor of 25 percent to their CAT Fund premiums. The 25 percent rapid cash buildup factor increased the premium homeowners pay for residential property insurance by 3 percent on average, although the premium increase per policyholder varied.

- Allows the CAT Fund to capitalize using capital market investment tools such as industry loss warranties, catastrophic bonds, sidecar arrangements, or specific financial contracts in order to bring more private capital into the CAT Fund.

FULL ANALYSIS

I. SUBSTANTIVE ANALYSIS

A. HOUSE PRINCIPLES ANALYSIS:

Provide limited government – The bill allows insurers to purchase additional coverage from the CAT Fund.

Empower families – The bill provides that if an insurer elects to purchase CAT Fund coverage at the lower retention level and/or at the higher capacity, the insurers must pass through all of the savings to the consumer.

B. EFFECT OF PROPOSED CHANGES:

The 2004 and 2005 Hurricane Seasons

The 2004 hurricane season was destructive for Florida, with four hurricanes causing extensive damage throughout the state. All four hurricanes occurred within a 45-day period beginning August 13, 2004, when Hurricane Charley[1] made landfall as a Category 4 hurricane; followed on September 5 by Hurricane Frances[2], a Category 2 hurricane. Next, Hurricane Ivan[3] struck on September 16 followed by Hurricane Jeanne[4] on September 26, which were both Category 3 hurricanes. The paths of the hurricanes indicated virtually no part of Florida is immune from hurricane risk. Allegedly, the 2004 hurricanes caused damage to an estimated one in every five homes in Florida.

For the most part, the insurance and reinsurance industry recapitalized after the 2004 hurricane season. That is, the capital lost by primary insurers and reinsurers was replenished. Additionally, the FHCF was able to pay its share of the losses out of cash reserves and maintain a cash balance to use to pay claims to start the 2005 hurricane season.

However, as the state was still recovering, recapitalizing, and rebuilding from the 2004 hurricanes, the 2005 season began. The 2005 hurricane season was also destructive for Florida, with four hurricanes hitting Florida for the second year in a row.

Hurricane Dennis hit on July 10, 2005 as a Category three hurricane. Hurricane Katrina hit Florida on August 25, 2005. At landfall in Florida, Hurricane Katrina was a Category 1 storm.[5] Although Florida did not sustain as severe damage as New Orleans, Louisiana, Biloxi, Mississippi and surrounding areas, Hurricane Katrina caused substantial damage in Florida. The next hurricane to hit Florida in 2005 was Hurricane Rita which made landfall on September 20, 2005 as a Category 2 hurricane.[6] Hurricane Wilma made landfall on October 24, 2005 as a Category 3 hurricane.[7] Hurricane Wilma was the costliest hurricane for Florida in 2005.

[1] http://www.nhc.noaa.gov/pdf/TCR-AL032004_Charley.pdf (last viewed January 3, 2007).
[2] http://www.nhc.noaa.gov/pdf/TCR-AL062004_Frances.pdf (last viewed January 3, 2007).
[3] http://www.nhc.noaa.gov/pdf/TCR-AL092004_Ivan.pdf (last viewed January 3, 2007).
[4] http://www.nhc.noaa.gov/pdf/TCR-AL112004_Jeanne.pdf (last viewed January 3, 2007).
[5] http://www.nhc.noaa.gov/pdf/TCR-AL122005_Katrina.pdf (last viewed January 3, 2007).
[6] http://www.nhc.noaa.gov/pdf/TCR-AL182005_Rita.pdf (last viewed January 3, 2007).
[7] http://www.nhc.noaa.gov/pdf/TCR-AL252005_Wilma.pdf (last viewed January 3, 2007).

The following chart illustrates the eight hurricanes' impact on the insurance industry:

Summary Data by Event and CY

Event	Data as of	Estimated Gross Probable Loss	Claims Reported	Total Loss Claims	Claim Payments Made
Charley	31-Dec-05	$10,158,404,847	474,771	17,679	$9,056,703,918
Frances	31-Dec-05	$7,952,635,936	541,589	14,105	$7,707,516,393
Ivan	31-Dec-05	$3,314,847,829	207,718	8,104	$3,205,437,734
Jeanne	31-Dec-05	$3,634,646,243	427,633	8,951	$3,513,823,790
CY2004 Total		$25,060,534,855	1,651,711	48,839	$23,483,481,835
Dennis	31-Dec-05	$297,399,185	52,934	920	$269,807,639
Katrina	30-Apr-06	$853,000,053	122,798	3,153	$725,223,536
Rita	30-Apr-06	$25,242,545	4,375	167	$19,447,845
Wilma	30-Apr-06	$9,659,383,823	975,717	18,853	$8,848,516,509
CY2005 Total		$10,835,025,603	1,155,824	23,093	$9,862,995,529
Overall Totals		**$35,895,560,458**	**2,807,535**	**71,932**	**$33,346,477,364**

Source: Florida Office of Insurance Regulation, Hurricane Summary Data, published August 2006.[8]

This chart illustrates the eight hurricanes' impact on the different lines of insurance. The line incurring the most impact was the homeowners one.

Event Totals by Lines of Business
CY2004 and CY 2005

Data as of 04/30/2006	CY2004 and CY2005 Combined		
	Claims Reported	Total Loss Claims	Claim Payments Made
Commercial Auto Physical Damage	21,958	416	$126,247,845
Commercial Multi-Peril	138,323	2,712	$5,641,902,527
Farmowners	2,909	68	$72,565,576
Fire & Allied Lines	337,614	5,022	$7,200,947,534
Flood	3,764	6	$50,572,939
Homeowners	1,582,848	48,472	$15,869,192,338
Mobile Homeowners	215,696	5,502	$2,364,824,992
Ocean Marine	217	1	$4,822,286
Other Lines	72,190	1,887	$927,831,013
Private Passenger Auto Physical Damage	432,017	7,847	$1,087,570,314
Totals by Line of Business	**2,807,535**	**71,932**	**$33,346,477,364**

Source: Florida Office of Insurance Regulation, Hurricane Summary Data, published August 2006.[9]

Insurers' losses from the 2004 and 2005 hurricanes as well as meteorological expectations that the increase in hurricane activity will continue for the foreseeable future have caused both insurers and reinsurers to reevaluate their tolerance for risk as well as the related amount of additional capital they

[8] According to the publication, the information contained in the chart is compiled from data submitted by each reporting entity and has not been formally audited or independently verified by the Office of Insurance Regulation.
[9] According to the publication, the information contained in the chart is compiled from data submitted by each reporting entity and has not been formally audited or independently verified by the Office of Insurance Regulation.

are willing to commit to Florida. Some insurers have added new underwriting restrictions to reflect changes in their exposure tolerance. Others have nonrenewed or cancelled policies. Still others have raised rates.

In addition, the insurance company rating agencies, such as Standard and Poor's and Moodys, have increased the amount of capital insurers and reinsurers must have to keep a favorable rating. Insurers need to maintain favorable ratings in order to ensure future capital contributions by stockholders.

The reinsurance market only partly recapitalized after the 2005 hurricanes.[10] Pricing at the beginning of 2006 for private sector Florida hurricane risk reinsurance increased 50-70percent from the prior year and increased another 50-100 percent on July 1, 2006.[11] Reinsurance rates covering Florida property are expected to lower some in 2007 as no hurricanes hit Florida in 2006, but are not expected to drop to pre-2004 rates.

Capacity: As a result of the hurricane damage in 2004 and 2005, insurance companies are enforcing stricter underwriting standards to limit their exposure in certain high risk areas or limiting types of properties they select to insure. In 2nd Quarter 2006, there were 167 companies writing personal residential coverage in Florida, a significant drop from the high of 225 companies writing personal residential coverage in 1998.

The number of companies actively writing property residential coverage has been declining steadily, even prior to the most recent hurricane activity. The market is dominated by five insurers – Citizens Property Insurance Corporation, State Farm Florida, Allstate Floridian, Nationwide of Florida and United Services Automobile Association. The number of companies actively writing in the commercial residential market, which includes condominiums and apartment buildings, is declining too.

Although insurance companies have made frequent rate increase filings since the 2004-2005 hurricane seasons, many believe it is not the rates which are inhibiting a growth in capacity. Although not under rate regulation, the surplus lines market is also contracting meaning it appears the private industry may have reached its threshold for risk in Florida's residential property markets. Although there have been mergers and acquisitions, over time fewer insurance companies are willing to insure property in the state. In addition, many of the property insurers willing to remain in the Florida market are either capping or reducing exposure. The manufactured housing insurance market also has tightened significantly. One in every five detached family homes in Florida is a manufactured home.

Availability: In theory, availability can be bifurcated into two issues: fewer companies are writing insurance and the companies that are writing have decreased the number of policies they are issuing. From a consumer perspective, less availability creates a considerable problem in a growing economy, which requires a constant infusion of new capital to compensate for the new homeowners entering the state. Some individuals who own their homes have the opportunity to "go bare," while the majority of people have mortgages that require homeowners' insurance.

One symptom of less availability is the increase in the number of policies in Citizens Property Insurance Corporation. Residual markets such as Citizens are often a measure of the "health" of a particular market – an increase in the number of policies in the residual market is a symptom of a troubled market. Regardless of the underlying reasons, there has been a general growth trend in the number of Citizens policies, which has continued through the last two storm seasons.

---

[10] The Task Force on Long Term Solutions to Florida's Hurricane Insurance Market report adopted March 6, 2006, page 12. (citing the Reinsurance Association of America); "A Study of Private Capital Investment Options and Capital Formation Impacting Florida's Residential Insurance Market," prepared by the State Board of Administration of Florida on September 19, 2006, page 3.

[11] "A Study of Private Capital Investment Options and Capital Formation Impacting Florida's Residential Insurance Market," prepared by the State Board of Administration of Florida on September 19, 2006, page 3.

A market that has absorbed some of the additional need for capacity is the surplus lines market. According to data from the Florida Surplus Lines Service Office (FSLSO), the amount of premium collected in 2002 on residential and commercial policies was $2.2 billion. Based on the most recent data available, as of October 1, 2006, the projected premium for 2006 will be $4.2 billion, an increase of 88 percent in five years.

Affordability: The resultant increases in insurance rates have created serious concerns for policyholders, legislators, and other leaders within state government. Property values and related taxes have escalated. Combined with insurance rate increases, Floridians are having difficulty absorbing these increases in the cost of living.

The Office of Insurance Regulation (OIR) is charged with the review of insurer rate filings to ensure rates are fair, adequate, and do not unfairly discriminate. Florida law does not authorize the Insurance Commissioner to determine whether or not insurance policies are "affordable." The Insurance Commissioner is vested with the responsibility to ensure that all rates are fair and adequate and commensurate with the risk, with a few exceptions.

Insurers are precluded from recouping prior losses; therefore, admitted insurers are not permitted to include hurricane losses from the 2004-2005 hurricane seasons in their current rates. In 2006, 52 of Florida's 167 property insurance carriers requested rate increases over 25 percent related primarily to the considerable increase in their cost to purchase reinsurance and the heightened expectations of future losses related to hurricanes (wind losses arising from hurricane loss models). Increases in property values also have contributed to the increase in insurance premiums as have substantial increases in the cost of labor and materials to re-build after an event.

Governor's Property and Casualty Insurance Reform Committee: On June 27, 2006, Governor Jeb Bush issued Executive Order 06-150 creating the Property and Casualty Insurance Reform Committee (Governor's Committee) to study Florida's insurance issues and make recommendations to the Governor, the President of the Senate, and the Speaker of the House of Representatives. The Governor's Committee met eight times throughout the state to obtain testimony about insurance issues facing Florida homeowners and commercial businesses. The Governor's Committee issued an Interim Report on November 15, 2006. In accordance with its charge from Governor Bush, the Governor's Committee made recommendations to improve competition and create incentives for private insurance and reinsurance in the areas of residential, commercial, manufactured homes, condominiums/apartments, and government entities; to depopulate Citizens Property Insurance Corporation (Citizens); to reduce the exposure of the Florida Hurricane Catastrophe Fund by substituting private alternatives; to evaluate the preliminary results of SB 1980 including the capital build-up program, mitigation program, private insurance competition and capacity measures, and Citizens' rate changes; and to influence national catastrophe risk management planning.

SB 1980 PROVISIONS RELATING TO FLORIDA HURRICANE CATASTROPHE FUND (FHCF)

During the 2006 Legislative Session, Governor Bush and the Florida Legislature worked to address the strained property insurance marketplace. The Legislature enacted Senate Bill 1980 (SB 1980, 2006-12, L.O.F.) which provided a myriad of reforms, including changes to the FHCF.

The legislation amended the Florida Hurricane Catastrophe Fund (FHCF or CAT Fund) to require a 25 percent rapid cash build-up factor in the premiums paid by insurers for coverage from the CAT Fund. The bill allowed limited apportionment companies (i.e., companies with $25 million in surplus or less), for one year only, to buy coverage from the FHCF that would reimburse the insurer for up to $10 million of its losses from each of two hurricanes above the insurer's retention, or the amount of hurricane losses the insurer must pay before triggering coverage from the FHCF, which is set at 30 percent of the company's surplus. The insurer must pay a rate of 50 percent of the coverage selected (i.e., $5 million for the maximum $10 million in coverage), which is reinstated at no additional charge for a second hurricane.

Florida Hurricane Catastrophe Fund (FHCF or fund)

Background

The Florida Hurricane Catastrophe Fund (FHCF or "fund") is a tax-exempt trust fund created after Hurricane Andrew as a form of mandatory reinsurance for residential property insurers.[12] All insurers who write residential property insurance in Florida are required to buy reimbursement coverage (reinsurance) on their residential property exposure through the FHCF. The FHCF is administered by the State Board of Administration (SBA) and is a tax-exempt source of reimbursement to property insurers for a selected percentage (45, 75, or 90 percent) of hurricane losses above the insurer's retention/deductible.

Because the FHCF provides insurers an additional source of reinsurance to what is available in the private market, insurers are generally able to write more residential property insurance in the state than could otherwise be written. Because reinsurance purchased through the FHCF is significantly less expensive than private reinsurance, the FHCF also acts to lower residential property insurance premiums for consumers.

The FHCF must charge insurers the "actuarially indicated" premium for the coverage provided, based on hurricane loss projection models found acceptable by the Florida Commission on Hurricane Loss Projection Methodology. Each insurer's "reimbursement premium" is different, based on the insured value of the residential property it insures, their location, construction type, deductible amounts, and other factors.

Under current law, the maximum amount the FHCF must pay (the capacity) in any one year is $15 billion, adjusted annually based on the percentage growth in fund exposure, but not to exceed the dollar growth in the cash balance of the fund.[13] The total industry retention is $5.3 billion per hurricane, also adjusted annually based on the FHCF's exposure (regardless of any change in the FHCF's cash balance).[14]

The FHCF generally operates on a "contract year." The contract year runs from June 1st to May 31st of the next calendar year. The start of hurricane season coincides with the start of the fund's contract year.

For the current 2006-07 contract year (June 1, 2006 – May 31, 2007), the insurance industry as a whole has an aggregate retention of $5.3 billion, meaning the total of all individual insurer retentions/deductibles will hypothetically total to $5.3 billion per event, assuming all participating insurers reached their retention. Although the insurance industry's aggregate deductible/retention totals $5.3 billion, loss recovery from the FHCF is based on an individual insurer meeting its own retention prior to losses being reimbursed. The industry aggregate retention is expected to grow to $6 billion for the 2007-2008 contract year.

Each insurer must meet a retention/deductible before FHCF monies are available to pay claims. The retention level for each insurer is different because the retention level is based on the amount of premium the insurer pays to the FHCF. Insurers with a high FHCF premium will absorb more as a retention/deductible than an insurer with a low FHCF premium. The insurer must meet its retention level for each storm in a hurricane season before the FHCF will step in to pay its claims. For insurers who experience losses due to multiple storms in a year, the insurer's full retention is applied to the two

[12] s. 215.555, F.S. (2006).
[13] s. 215.555(4)(c)1., F.S. (2006).
[14] s. 215.555(2)(e)1., F.S. (2006).

storms causing its two largest losses and its retention for the other storms causing loss is one-third of the full retention.[15]

As with the FHCF retention/deductible levels, every insurer participating in the FHCF has coverage based on its FHCF reimbursement premium. Each insurer has a maximum amount of coverage the FHCF will pay for claims each year. The maximum amount of coverage is different for each insurer because it is linked directly to the amount of premiums the insurer pays to the FHCF. Thus, insurers that pay higher premiums to the FHCF have more coverage than those that pay lower premiums. For the current contract year (2006-2007), the insurance industry as a whole is covered for up to $15 billion, meaning $15 billion is the most the FHCF will pay to the insurance industry on claims for a hurricane season. The coverage limit for the fund for the 2007-2008 contract year is expected to grow to $16 billion because the FHCF is not expected to have to reimburse insurers for losses during the 2006-2007 contract year as no hurricanes have hit Florida. Thus, the FHCF's cash balance will grow in the 2006-2007 contract year leading to an increase in the FHCF's capacity. With cash available of $2.2 billion, the fund's 2007 bonding capacity is $13.8 billion.

Additionally, insurers also choose a percentage level of reimbursement by the FHCF. By statute, insurers can select 45, 75, or 90 percent coverage reimbursement for losses that exceed its deductible/retention for each hurricane.[16] Most insurers choose the 90 percent reimbursement percentage.[17] This means once an insurer triggers FHCF coverage, 90 percent of its losses will be covered by the FHCF, up to the insurer's limit of coverage. Insurers may purchase additional reinsurance in the private market to cover their hurricane losses for amounts below the retention, amounts above their reimbursement limit, or for the coinsurance amount (e.g., 10 percent) that is the insurer's responsibility for the layer of coverage provided by the FHCF.

If the cash balance of the fund is not sufficient to cover losses, the law allows the issuance of revenue bonds, which are funded by emergency assessments on property and casualty policyholders.[18] The FHCF is authorized to levy emergency assessments against all property and casualty insurance premiums paid by policyholders (other than workers' compensation and, until June 1, 2007, medical malpractice), including surplus lines policyholders, when reimbursement premiums and other fund resources are insufficient to cover the fund's obligations.[19] Annual assessments (which will be levied for the first time starting January 1, 2007) 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.[20]

Impact of 2004 and 2005 Hurricanes on FHCF

At the start of the 2004 hurricane season, the FHCF had $6.2 billion cash available to reimburse insurers. The FHCF is expected to pay out $3.95 billion to insurers as a result of the 2004 hurricanes; to date, the fund has already paid $3.7 billion to insurers. Because the amount paid in 2004 was less than the FHCF's cash balance, bonding was not necessary.

At the start of the 2005 hurricane season, the FHCF had $3 billion cash available to reimburse insurers. To date, the FHCF has paid out $3.5 billion to insurers due to the 2005 hurricanes; the fund is expected to pay out $4.5 billion. Thus, the fund had a $1.425 billion deficit due to the 2005 hurricanes. The 2005 deficit of $1.425 billion was funded from $1.35 billion of post-event bond issuance. This is the first time the fund has had to bond to cover a deficit since its creation in 1993. The bonding resulted in a 1 percent assessment for six years against all property and casualty insurance policyholders except workers' compensation and medical malpractice starting January 1, 2007. An additional $200 million of the FHCF deficit was funded by a 25 percent surcharge on FHCF premiums paid by insurers in 2006 (rapid cash build up factor). The FHCF was required to include this factor in its premiums by SB 1980.

[15] s. 215.555(2)(e)4., F.S. (2006).
[16] s. 215.555(2)(e)2., F.S. (2006).
[17] Florida Hurricane Catastrophe Fund, Fiscal Year 2004-2005 Annual Report 23.
[18] s. 215.555(6)(a)1., F.S. (2006); s. 215.555(6)(b)1., F.S. (2006).
[19] s. 215.555(6)(b)1., F.S. (2006); s. 215.555(6)(b)(10), F.S. (2006).
[20] s. 215.555(6)(b)2., F.S. (2006).

Including a rapid cash buildup in the fund did not increase the amount of fund coverage insurers had; insurers simply paid more in premiums due to the rapid cash buildup for the same amount of coverage.

Because the FHCF did not have cash to carry over to fund claims resulting from the 2006 hurricane season, it issued $2.8 billion is pre-event notes to provide liquidity for the 2006 hurricane season. No assessment is required to cover these bonds as the funds are invested and earning enough interest to pay the debt service on them. If proceeds of the notes are spent for future claims, the notes will be refinanced using tax-exempt post –event bonds secured by emergency assessments. For the current 2006-2007 contract year, the fund's $15 billion capacity consists of $0 in cash and $15 billion in bonding capacity.

In summary, from the inception of the fund in 1993 until the 2004 hurricane season, the fund paid insurers for claims for only two hurricanes, Hurricanes Erin and Opal in 1995. Until 2004, the amount the FHCF paid to insurers totaled approximately $13 million. Thus, going into the 2004 hurricane season the FHCF had accumulated over $6 billion in cash. As a result of the 2004 hurricanes, the fund has spent or expects to spend almost $3.95 billion of its cash reimbursing insurers for hurricane losses. Going into the 2005 hurricane season, the fund's cash had decreased to $3 billion. With reimbursement to insurers for 2005 hurricane losses expected to be $4.95 billion, the fund had to bond for $1.35 billion. Thus, it is important to note that the $6 billion it took the FHCF to accumulate over ten years was depleted in just two years.

Proposed Changes

For two years, the bill allows insurers to purchase additional coverage from the CAT Fund at a rate lower than the private reinsurance rate for lower retention levels (TEACO) and for higher capacity levels (TICL). Insurers are able to lower their retention level by a maximum of $4 billion in $1 billion increments. Insurers are able to increase their capacity level by a maximum of $4 billion in $1 billion increments. For the 2007-2008 contract year, if an insurer chose to purchase the maximum amount of additional FHCF coverage, under this plan, the FHCF coverage will be provided as low as $2 billion and as high as $20 billion.

If an insurer elects to purchase CAT Fund coverage at the lower retention level and/or at the higher capacity level, the insurers must pass through 100 percent of the savings they receive from their purchase to consumers. In no case may an insurance company provide less than a 25 percent reduction in premiums for its purchase of CAT Fund coverage at a lower retention level and/or higher capacity level, unless it applies for and receives a waiver from the Financial Services Commission.

After the 2-year period, the CAT Fund retention and capacity would be governed by statutory formula, but the State Board of Administration (SBA) would be empowered to reset the retention level and capacity with the approval of the Legislative Budget Commission (LBC). Although the TEACO rate/price is set by statute, the SBA is authorized to amend this rate/price with the approval of the LBC.

The bill repeals the rapid cash buildup factor in the CAT Fund, which requires insurers to add a factor of 25 percent to their CAT Fund premiums. The 25 percent rapid cash buildup factor increased the premium homeowners pay for residential property insurance by 3 percent on average, although the premium increase per policyholder varied.

USE OF CAPITAL MARKET PRODUCTS TO TRANFER RISK

The problems in the Florida insurance marketplace can be bifurcated into two related issues: price and availability. One of the clearest lessons from the 2004-2005 hurricane seasons is that a healthy competitive private insurance market requires capital, and the absence of the necessary capital leads to higher priced products and fewer products available for sale.

The goal of any reform proposal must be to increase incentives for the private industry to augment available capital, potentially even leveraging public resources to increase this capital, as well as removing the barriers that provide a disincentive for capital creation.

To date, the majority of effort to improve the personal and commercial residential markets has focused on the capital side. The goal has consistently been to raise more capital to create more capacity that facilitates more insurance products, more competition, and lower prices. However, there are other mechanisms that can be utilized to create more capacity, specifically, by raising capital through the transfer of risk to other entities such as investors.

Catastrophe Bonds

In its most rudimentary form, the U.S. financial markets can be divided into two categories: stocks (equity capital), and bonds (debt instruments). One of the more popular sources of risk capital outside of the traditional reinsurance market is the growing catastrophe bond market. Cat Bonds have been in the market for about 10 years. Current demand is strong and growing among institutional investors and hedge funds for these debt instruments. These instruments allow institutional investors a chance to earn fairly lucrative returns and to diversify their portfolio holdings. However, the ability to participate in this market by issuing catastrophe bonds to raise capital is generally limited to very large insurance companies, reinsurance companies, and noninsurance commercial ventures.

The basic concept of a catastrophe bond is that a company issues a bond, and in exchange for an upfront purchase price, pays interest on the bond to whoever purchases the bond. Investors could be banks, hedge funds, commercial business, or private investors -- thus expanding the base of capital far beyond the traditional insurance companies and reinsurance companies. Under a typical catastrophe bond, if catastrophe losses of the specified type occur above a predetermined amount, the issuer is relieved of its obligation to repay principal and/or interest.

Cat Bonds are essentially a form of excess-of-loss reinsurance that provides more permanence than a typical reinsurance policy: e.g., three to five years versus one year for a typical reinsurance policy. The total amount of Cat bonds outstanding is about $10 billion. However, year-to-date 2006 issuance of almost $3 billion is already the largest year ever and market observers believe that full year issuance may exceed $5 billion. Cat bonds are the most well-established of the capital markets catastrophe risk transfer mechanisms, and some market observers believe they are poised for rapid growth in the near future. At this time, however, Cat bond issue size has rarely exceeded $200 million and there is very limited liquidity in the secondary market. The complexity of the instrument used in issuance of Cat bonds (SPRV=Special Purpose Reinsurance Vehicle) has been a drawback to its growth; however, investors have become comfortable with the general features and investment thesis of Cat bonds, and structuring improvements have contributed to both enhanced transparency and greater sophistication (especially in the calculation of the index triggers) of the instrument.

The majority of Cat bond transactions are arranged and established offshore, especially in Bermuda, the Cayman Islands, and Ireland. The National Association of Insurance Commissioners (NAIC) has attempted to address this issue by the creation of a model act that allows U.S. insurance companies to effectively create the offshore mechanism domestically, defined as a special purpose reinsurance vehicle. To date, only a few states have adopted the law, and it has not yet been adopted in Florida. If adopted, it would give insurers another tool for arranging and managing their capital and risk.

Industry Loss Warranties (ILWs)

ILWs are index-based reinsurance contracts that pay off when a specified trigger or triggers are met. ILWs are functionally equivalent to traditional excess-of-loss reinsurance for companies seeking to transfer risk, but they may have certain advantages. Usually there are two triggers – one (the indemnity trigger) says a minimum threshold of firm losses must occur before any payout is received under the contract; the second (the index trigger) says that a certain level of industry losses must also occur before any payout under the contract can take place. The second trigger is the focus of the contracts,

and the one from which they derive their name. The first trigger is generally included so that the contracts qualify as reinsurance.

ILWs first came into existence in the airline industry in the mid-1980s during a time of reinsurance shortage. They have in recent years been adapted to the property and casualty insurance industry as one more reaction to the growing realization that large-scale catastrophe risk must be spread over a base that is larger than the available capital in the traditional reinsurance sector. ILWs are attractive to nontraditional market participants (hedge funds, etc.) because they are an indexed product with relatively low transaction costs that can provide noncorrelated risk to a diversified investment portfolio. They are attractive to insurers and reinsurers because they are a relatively inexpensive way to transfer catastrophic risk, though basis risk is retained, since a company's losses may not reflect industry losses.

Examples of ILWs may include terms that require payment if the following types of events occur:
1. A hurricane with industry-wide insured loss in Florida in excess of $15 billion but less than $25 billion.
2. A winter freeze with industry-wide insured loss in North America in excess of $20 billion.
3. An earthquake with industry-wide insured property loss in excess of $35 billion anywhere in the world.
4. Second wind loss with industry-wide insured loss in excess of $10 billion anywhere in the US and territories.

Various sources estimate the amount of coverage provided by existing ILWs at between $5 billion and $7 billion. There is little doubt that the market is growing rapidly, with issuance in the last 12 months over $4 billion. As the market grows, additional secondary market trading has begun in the product, although ILWs are not considered as a liquid instrument. This may not be a critical drawback, since most ILWs are short-term in nature, thereby reducing the value of liquidity. Some observers have noted that this instrument may have a very high potential for growth akin to the explosion in credit default swaps over the past decade.

Sidecars
Sidecars are a relatively new phenomenon in the property and casualty insurance arena, appearing first in 2005. They can be thought of as "an insurance company within an insurance company." In other words, a sidecar is a reinsurance company that reinsures only one other company: the sponsoring insurer. It generally provides this reinsurance on a fully collateralized basis. Unlike Cat bonds and ILWs, which functionally provide excess-of-loss coverage, sidecars provide quota-share like coverage (i.e., they share in the premiums and losses of the ceding company proportionally). Participants in sidecars include the sponsoring insurer and outside investors, both of whom contribute capital to the endeavor under specified terms and for a relatively short period (usually two years or less). Sidecars are popular with sponsoring insurers because they provide a means to transfer risk and provide significant amounts of additional capacity. For investors (primarily hedge funds and private equity), sidecars provide high expected returns (higher than Cat bonds), a pure play on a specified catastrophe risk (free from any concerns about legacy balance sheet defects), and easy exit strategies for capital. However, sidecars typically require a significantly larger investment than Cat bonds – as much as $200 million, compared to $10 million for Cat bonds. Like Cat bonds, sidecars are complex transactions that can be costly both in terms of time and money to organize.

Proposed Changes
The bill allows the CAT Fund to capitalize using capital market investment tools such as industry loss warranties, catastrophic bonds, sidecar arrangements, or specific financial contracts in order to bring more private capital into the CAT Fund.

C. SECTION DIRECTORY:

Section 1. Provides a short title.

Section 2. Amends s.215.555, relating to Florida Hurricane Catastrophe Fund.

Section 3. Creates an unnumbered statute, requires that any insurer electing TEACO or TICL coverage option make a rate filing with the office reflecting 100 percent of the reduction in loss exposure to the insurer and requires the insurer to provide a 25 percent reduction in premium based under TEACO coverage. Provides that the FSC may grant a waiver for 25 percent reduction for good cause. Authorizes the office to specify by order the date for such filings to be made and rate reduction given to policyholders.

Section 4. Provides an effective date of upon becoming law.

II. FISCAL ANALYSIS & ECONOMIC IMPACT STATEMENT

A. FISCAL IMPACT ON STATE GOVERNMENT:

1. Revenues:

   None.

2. Expenditures:

   None.

B. FISCAL IMPACT ON LOCAL GOVERNMENTS:

1. Revenues:

   None.

2. Expenditures:

   None.

C. DIRECT ECONOMIC IMPACT ON PRIVATE SECTOR:

Offering insurers the opportunity to lower their FHCF retention level and increase their capacity level should lower rates for insurers purchasing the optional coverage because the insurer will be paying less for such reinsurance with the FHCF than with the private market. However, this is only true for those insurers that purchase coverage in the private market at the TEACO and TICL levels at a price greater than the price similar coverage (at TEACO and TICL levels) is being sold by the FHCF. In addition, for those insurers who buy coverage at the TEACO and TICL levels in the private market at a price less than the price similar coverage (at TEACO and TICL levels) is being sold by the FHCF and who decide to buy TEACO and TICL coverage from the FHCF to replace their cheaper coverage, rates for the policyholders of those insurers may increase. This is because the insurer is replacing cheaper reinsurance purchased in the private market (possibly purchased from a parent company) with TEACO and TICL coverage sold by the FHCF that is more expensive.

The bill requires the FHCF to sell reinsurance below its current retention level as follows but allows the SBA to amend the rate consistent with prudent management and with LBC approval:

$1 billion below the current retention level: 30% rate-on-line[21]
$2 billion below the current retention level: 35% rate-on-line
$3 billion below the current retention level: 40% rate-on-line
$4 billion below the current retention level: 50% rate-on-line

It is estimated private reinsurance at these levels is currently priced at[22]:

$1 billion below the current retention level: 72% rate-on-line
$2 billion below the current retention level: 75%rate-on-line
$3 billion below the current retention level: 80% rate-on-line
$4 billion below the current retention level: 91% rate-on-line

Thus, the savings accruing to an insurer purchasing lower FCHF retention is the difference between what the insurer would pay in the private market for reinsurance at that retention level and what the FHCF will charge for it. It is difficult to predict how much each particular insurer will save as it is uncertain if or at what level each insurer will purchase TEACO and TICL from the FHCF. The savings will vary for each insurer, depending on what coverage levels it chooses. Thus, policyholders with different insurers will likely see different savings and policyholders with the same insurers may see different savings due to rating differences between territories and other rating factors.

The bill requires the FHCF to sell reinsurance above its current capacity level as follows but allows the SBA to amend the rate consistent with prudent management and with LBC approval:

$1 billion above the current capacity level: 20% rate-on-line
$2 billion above the current capacity level: 17.5% rate-on-line
$3 billion above the current capacity level: 15% rate-on-line
$4 billion above the current capacity level: 14% rate-on-line

It is estimated private reinsurance at these levels is currently priced at[23]:

$1 billion above the current capacity level: 43% rate-on-line
$2 billion above the current capacity level: 38% rate-on-line
$3 billion above the current capacity level: 34% rate-on-line
$4 billion above the current capacity level: 30% rate-on-line

Thus, the savings accruing to an insurer purchasing increased FHCF capacity is the difference between what the insurer would pay in the private market for reinsurance at that capacity level and what the FHCF will charge for it. It is difficult to predict how much each particular insurer will save as it is uncertain if or at what level each insurer will purchase TEACO and TICL from the FHCF. The savings will vary for each insurer, depending on what coverage levels it chooses. Thus, policyholders with different insurers will likely see different savings and policyholders with the same insurers may see different savings due to rating differences between territories and other rating factors.

Repeal of the rapid cash buildup factor in the CAT Fund, which requires insurers to add a factor of 25 percent to their CAT Fund premiums, will reduce residential property insurance premiums by 3 percent on average, although the premium decrease per policyholder will vary.

[21] Rate-on-line means the premium paid by an insurer to a reinsurer as a percentage of the reinsurer's exposure. The CAT Fund currently sells reinsurance at about 6.7% rate-on-line, meaning an insurer has to pay 6.7 cents for a dollar's worth of reimbursement coverage.
[22] Information on private reinsurance rate-on-line obtained from the Office of Insurance Regulation.
[23] Information on private reinsurance rate-on-line obtained from the Office of Insurance Regulation.

D. FISCAL COMMENTS:

Although the impact of the bill does not directly affect revenues or expenditures of any state funds, significant disaster events in Florida may create pressure for the state to contribute State funds or incur state obligations in lieu of FHCF bond debt and the corresponding assessments on citizens' insurance policies. Bond debt incurred by the FHCF is classified as indirect state debt. Indirect debt is debt that is not secured by traditional State revenues or is the primary obligation of a legal entity other than the State. According to the Division of Bond Finance, the indirect State debt for 2006 is estimated to be $16.667 billion, while state tax-supported debt for 2006 is $17.866 billion. The state indirect debt was only $6.492 billion in 2005, but grew by $4.15 billion due to recent FHFC financing and by another $3.050 billion due to recent Citizens Property Insurance Corporation financing. Indirect debt is of interest because to many persons it represents the state's exposure from the standpoint of a moral obligation to pay, should the financing mechanisms in place to repay that debt fail. Under the provisions of this bill, total indirect state debt could increase by a maximum of $22 billion, which would represent a 55 percent increase in total state debt (currently at $39.693 billion when the self-supported state debt is included with the direct and indirect debt).

The maximum payout for the FHCF with the TEACO and TICL options is $28 billion whereas the maximum payout under the current law is $16 billion (for the 2007-2008 contract year). The FHCF anticipates it will collect $1.2 billion in premium for the 2007-2008 contract year for its regular mandatory coverage and estimates it will collect an additional $2-3 billion for the optional TEACO and TICL coverage. Thus, under a scenario where all insurers opt to purchase the maximum coverage they can from the FHCF using TEACO and TICL causing the FHCF to grow to its maximum capacity under TEACO and TICL and all insurers trigger the FHCF and obtain their maximum reimbursement from it, the FHCF would have to bond for $22 billion (for 2007-2008 contract year). A $15 billion bond translates to a 3 percent assessment for 30 years against the FHCF assessment base.[24] Accordingly, a $22 billion bond would require assessments somewhere between 3 percent and the FHCF maximum of 6 percent a year for 30 years. This assessment would be against all property and casualty insurance premiums paid by policyholders (other than workers' compensation and, until June 1, 2007, medical malpractice), including surplus lines policyholders.

III. COMMENTS

A. CONSTITUTIONAL ISSUES:

1. Applicability of Municipality/County Mandates Provision:

The mandates provision does not apply because this bill does not: require counties or municipalities to spend funds or to take an action requiring the expenditure of funds; reduce the authority that municipalities or counties have to raise revenues in the aggregate; or reduce the percentage of a state tax shared with counties or municipalities.

2. Other:

None.

B. RULE-MAKING AUTHORITY:

None provided in bill.

C. DRAFTING ISSUES OR OTHER COMMENTS:

None.

[24] The FHCF assessment base is all property and casualty insurance premiums paid by policyholders (other than workers' compensation and, until June 1, 2007, medical malpractice), including surplus lines policyholders. This includes auto owners and business owners.

IV. AMENDMENTS/COMMITTEE SUBSTITUTE & COMBINED BILL CHANGES

On January 16, 2007, the Jobs & Entrepreneurship Council heard the bill, adopted 2 amendments, and reported the bill favorably with Proposed Council Substitute. The amendments made the following changes to the original bill:

- Allows the State Board of Administration to change the rates set by statute for TEACO coverage with LBC approval.
- Corrects a technical error in the contract date of the Florida Hurricane Catastrophe Fund.
- Removes some legislative intent language.

The staff analysis was updated to reflect adoption of the amendments.