CURRENT STATE OF FLORIDA PROPERTY INSURANCE
December 2012

The Problem

Florida may be called the Sunshine State, but the state's occasional less-than-sunny weather during the hurricane season stands at the core of the problems facing its property insurance market. There is little the state can do to alleviate its position as a peninsula uniquely prone to experience hurricanes and tropical storms. But the problems of its insurance regulatory system are strictly manmade.

In particular, reacting to voters' concerns about high property insurance rates, lawmakers created a government-run property insurer (Citizens Property Insurance Corp.) and a government-run reinsurer (the Florida Hurricane Catastrophe Fund) that simply cannot handle the risk they face. Actually, they are expressly designed not to.

The Situation

By all accounts, Florida has the most hurricanes of any state. While Florida covers only about 1.5% of the lower 48 states' land area, it has been struck by seven of the ten costliest hurricanes in US history. Many of Florida's residents live in coastal areas where the risk is greatest, and the number has increased in recent years. Florida has $2.46 trillion in total coastal exposure, the most of any state. By comparison, the combined coastal exposure of other "hurricane alley" states (VA, NC, SC, GA, AL, MS, LA and TX) is only about $1.83 trillion.

Because the State fundamentally cannot decrease the likelihood, frequency, or intensity of the tropical cyclones its residents will face, it must cope with its vulnerability in other ways. These ways should include physically fortifying its buildings and infrastructure to better withstand windstorms and tidal surge, and improving the state's property insurance system to ensure that risks are spread broadly to entities with the financial strength to respond to disaster. On that score, the state-run mechanisms that were created to underwrite hurricane risk are in severe trouble.

Citizens Property Insurance Corp. (CPIC) is the state's largest writer of property insurance and the third largest underwriter of property insurance in the country. Although it maintains the façade of a private insurance sector insurer, including corporate structure with a CEO at the helm, CPIC is actually an unusually powerful government agency, exempt from most purchasing and hiring rules. Because it is essential for this government entity to have the maximum financial resources to pay claims following a catastrophic hurricane, it is the intent of Legislature that CPIC continue to be an integral part of the state, that the income of the corporation be exempt from federal income taxation, and that interest on the debt obligations issued by the corporation be exempt from federal income taxation.

Citizens is close to being able to cover a single major event – it has the ability to pay $19.5 billion in claims – close to the roughly $22 billion maximum expected damage of a major event. But more than $5 billion, or close to a fourth of the claims-paying funds, are from loans that would have to be paid back (via the taxpayers).

Not only is CPIC sponsored by FL's government, but it also has the authority to impose a form of taxation on nearly every insurance policy issued in the state, potentially impacting citizens, businesses, and civic

organizations statewide. When Citizens runs a deficit of greater than 10%, it has the unilateral power to impose assessments sufficient that “the entire deficit shall be recovered through regular assessments of . . . insurers [and] insureds.” Citizens must first impose surcharges on its own policyholders, but may subsequently impose assessments on every property and casualty insurance policy issued in the state except for medical malpractice and workers’ compensation policies.

CPIC was chartered as an “insurer of last resort” - or residual market - open only to those property owners who were legitimately unable to find coverage in the private market. However, former Gov. Charlie Crist’s 2007 insurance reforms allowed Citizens to offer policies to any Floridian who gets even a single insurance quote more than 15% greater than Citizens’ rates. Additionally, the 2007 legislation required Citizens to roll back its premiums to 2006 levels and freeze them there. These changes transformed CPIC from a residual market mechanism into an active competitor in the property insurance marketplace. It is a state-owned behemoth with a number of unfair advantages. In fact, a commission appointed to review CPIC found the agency charged rates that would be illegal for a private company to charge because they were not actuarially sound.

The result is that, by mid-year 2011, CPIC controlled 22.2% of FL’s personal and commercial residential policies in force and was adding new policies at a faster clip than any private insurer in the state. With its imposing size and its power to impose assessments to cover its own shortfalls, Citizens ultimately places Floridians themselves on the hook for its hundreds of billions of potential losses. This serious threat to Florida taxpayers is heightened by the extent to which Citizens relies on another taxpayer-backed entity – the Florida Hurricane Catastrophe Fund – to provide most of its reinsurance support following a catastrophe.

The FHCF is a state-run reinsurance corporation that is the largest provider of reinsurance in FL and one of the largest in the world. It was established in 1993 to provide reinsurance capacity for Florida insurers after losses from Hurricane Andrew led to a sharp reduction in capacity in the state. Like private reinsurers, FHCF provides insurance to insurance companies. When insurers’ total losses exceed certain levels, FHCF promises to cover a portion of the risk. In return for these promises, the FHCF collects premiums from insurers. Unlike private reinsurers, the FHCF does not actually keep on-hand the funds necessary to pay most of its claims. Instead, if it runs short on money, it has the authority to issue bonds, which it repays by imposing assessments on policies. All Floridians currently pay taxes on their insurance policies to pay off the FHCF’s debts from the 2004 and 2005 hurricane seasons . . . roughly a third of the FHCF’s total coverage goes to support CPIC.

A point of importance: while virtually all private reinsurers of any size have an international scope, the FHCF writes business only in Florida. Where a private company would balance the risk of hurricanes in Florida by taking on, for example, medical malpractice or workers’ comp risks, or the risk of earthquakes in CA or Japan, the FHCF cannot. In sum, the FHCF turns the principle of diversification on its head by concentrating FL’s peak hurricane risk within the state, rather than spreading it around the world. This means that, even assuming the FHCF has management talent and investing opportunities equal to those in the private sector, it must charge higher rates than the private sector would if it hopes to break even in the long run. Instead, it charges substantially lower rates than the private sector for comparable coverage.

The result is the FHCF, unless reformed, will ultimately cost the state of FL a massive amount of money. Recently, a senior official at FHCF urged lawmakers to reduce the fund’s role as a reinsurer in the state after a report estimated that the fund could face a $3.2 billion shortfall if a major storm were to hit. While the report emphasized that it used conservative guidelines to estimate the FHCF’s ability to raise

funds to pay claims, the fund's capacity should still be reduced by about $5 billion, according to the official. Insurance industry observers also echoed similar concerns that the FHCF may be exposed beyond its ability to raise money to pay claims.

Based on current exposures, the fund could face claims of $18.39 billion if a major hurricane were to hit this year, according to the 18 October report prepared by Raymond James & Associates, Inc. The FHCF is projected to have a year-end balance of $7.17 billion. However, the basis for calculating the fund's ability to meet its obligations also factors in the state's ability to raise money through municipal bonds after a catastrophe. According to the report, the FHCF would be able to raise $8 billion through bond issues in the 12-24 months after the event, leaving a potential shortfall of about $3.2 billion. The $8 billion loan would be paid back with a surcharge placed on every property and auto insurance policy in the state.

However, Goldman Sachs has a different view than Raymond James – stating that Florida likely could borrow no more than $4 billion following a storm, advising that the financial meltdown had eliminated a "whole class of investors" who would have been willing to lend money to the FHCF.

"We have a situation where if we had an event, we might not have enough money to pay for all the coverage purchased from the fund," said FHCF COO Jack Nicholson. He said, depending on the size of the event, some insurers might not be able to wait two years to receive the reinsurance claims payouts.

According to A.M. Best Co., Inc., the FHCF is in better shape now than three years ago, as they've been able to build up cash because there haven't been significant events in Florida. However, A.M. Best has "some skepticism" about the fund's ability to meet claims obligations in the event of a major catastrophe.

While the financial outlook for the fund has improved, there is still concern whether it will meet its statutory obligation to have enough funds for two hurricane seasons. By state law, the reinsurance facility that all property insurers in the state participate in must have $17 billion in funds for a *single* hurricane season and $11 billion for a second season. However, due to the dramatic down turn in the worldwide bond markets following tsunami in Japan and CA earthquakes, there have been questions of whether the facility could raise those kinds of funds. The fund's financial advisors (in their October 2011) estimates said it would only have $7 billion in cash and at best could issue $7 billion in bonds, leaving it $3.2 billion short of the $17 billion that it is required to reimburse insurers' losses in a single storm season. Another $11 billion in bonds would be needed for a second hurricane season . . . adding that to the first season's $3.2 billion shortfall, the FHCF would need to issue $14.2 billion in bonds, making it one of the highest bond deals on record. To put that in perspective, the largest municipal bond deal executed since 2009 was a CA $6.5 billion bond issuance and no state ever has issued more than $11 billion in bonds all at once.

The alternative is that if the FHCF exhausts its resources after a single hurricane season and can provide no other coverage during a second storm season, insurers would be left to scramble for private reinsurance at prices that could result in them withdrawing from the market.

The Bottom Line

Florida rolls the dice with citizens' dollars every hurricane season. Taxpayers back up the fund, which keeps rates artificially low. Florida leaders for too long have tried to mask the true costs of the

insurance marketplace. Florida lawmakers have put taxpayers at risk by not reforming the FHCF or Citizens Property Insurance Corp., but the proposals for reform are not popular because they would end up raising insurance rates.

Citizens continues to take on 8000 new policies a week, and notwithstanding substantial depopulation activity late this year its policy count will drift back up as fewer policies are assumed prior to the 2013 hurricane season. The underlying issue is fairly simple – the legislature froze Citizens' rates several years ago and when it finally lifted the freeze it set a cap on annual rate increases that has assured Citizens' rates lag the market. In short, Citizens' population program outweighs its depopulation program. By selling its product at a subsidized rate below the private sector costs, Citizens will continue to have plenty of new customers. Worse, it will take on these customers faster than it can send them back to the private market through depopulation initiatives. This is because the private market will take out the policies it perceives to be rate adequate, while the inadequately rated policies will stay behind with Citizens.

According to the president and executive director of the Association of Bermuda Insurers and Reinsurers (ABIR), the state's lawmakers put politics ahead of the public interest. "The legislature's failure to act this year is a sign of election year politics trumping sound fiscal policy and long term consumer protection." He also said FL policyholders risk higher hurricane tax assessments, higher hurricane insurance prices and the risk that their insurer will become insolvent due to the inability of the FHCF to fully pay its hurricane reimbursement obligations to ceding insurers.

Jack Nicholson, FHCF COO noted that in three of the last four years, the FHCF has been mandated by law to sell catastrophic protection to Florida's ceding insurers but, due to bond market volatility, would not likely have been able to issue sufficient bonds to pay all the claims from a large hurricane.

Reinsurers like those represented in ABIR provide "dependable, growing capacity" to meet US consumer needs, and in addition have capital in the bank to pay their claims, unlike the FHCF that is deficient. The FHCF is dependent on bond debt and assessments on all Florida consumers to pay their claims. These bonds saddle future consumers with an unnecessary and growing debt burden. Politically inspired restrictions on the ability of reinsurers to provide capacity for their clients represent the biggest threats to US "cat" markets.

The Solution

Mr. Nicholson has proposed that FL lawmakers limit the FHCF's capacity to $12 billion by 2016. During a September FL Senate Banking and Insurance Committee meeting, he was asked if reducing the fund's capacity would ultimately result in higher rates for consumers – "absolutely." His conclusion was to "right-size" the fund, which means either reducing risk or increasing cash reserves on hand. Again this past year, lawmakers were asked to scale back the size of the fund, a move that would have caused insurance premiums to rise . . . but the legislation stalled and was not passed. The FHCF should be structured so it can every year deliver the reinsurance that it sells . . . unfortunately, the political environment in the past has been to ignore the problem.

Citizens took preliminary steps in September to approve a new plan to lend private insurers up to $350 million in surplus funds to take over some of the Citizens' policies. Under the depopulation plan, Citizens would provide loans to companies that meet financial requirements, with the size of the loan contingent on the amount of risk they take on. The risk would be determined by the amount of

premium paid into the FHCF for each policy. The hope is that tying the loans to the FHCF calculation would entice companies to take on more risk and prevent “cherry picking” of safer, more inland policies. The loan would be paid off over 20 years. Critics of the plan cite concerns over a plan to loan funds from Citizens’ surplus and questioned the process to do so. Other lawmakers are worried that Citizens could lend money to private companies that could eventually go bankrupt without repaying the loan and cite concerns about whether Citizens has the statutory authority to lend money. The proposal is not the first depopulation plan used by Citizens, but it is the first to include monetary incentives for private insurers.

Prior to this, Citizens has agreed to rate increases, but those increases were subject to a 10% annual cap. This year CPIC reported the capped average increase (for homeowners policies) statewide would be less than 8%. However, the insurer reported that it actually needs an increase of 27% - 34%.

No one wants higher insurance rates, but Floridians insured outside of Citizens should not be on the hook for Citizens’ subsidized rates (however, a new law took effect July 2012 that shifts more of the burden of post-disaster assessments back to the Citizens policyholders). If Citizens bought reinsurance similar to the private market, the risk of assessments would decrease dramatically. If Citizens had bought reinsurance between 2006 and 2011 to the level of Florida domestic insurance companies, their cost would have been approximately $1.2 billion per year for a total cost of $7.2 billion. Currently, Citizens has $6 billion in cash, leaving them $1.2 billion short of the *true* reinsurance cost. This shows that Citizens’ rates are not actuarially sound – and that’s without a major storm, so imagine what a storm could do. Keeping the Citizens’ rates low will continue to drive private insurance companies out of Florida and put the financial burden on the policy holders when the next storm hits, along with a 61% surcharge the first year after the storm.

In summation, it’s interesting to note that the size of the residual/state-run insurance market in a given area if often a good indicator of the overall health of that particular insurance market: the larger the residual market, the more challenging the insurance climate/market usually is in general. And this holds true in Florida. Much of the challenge in Florida for private insurers has been a complex regulatory environment and historical rate suppression in the private market, combined with the fact that Citizens’ rates are well below the private market and have not been allowed to increase due to governmental action to cap rates. At the same time, most would agree that Citizens serves as a necessary resource for coverage in a difficult and challenging insurance market for some Floridians living in high risk areas.

We are in a catch-22 situation if they increase rates as they should. It has some unintended consequences, because you have some geographic areas in our state where the consumer would not be able to find affordable insurance coverage. Unfortunately, the real answer is to fix the insurance industry so that the private carriers get back in the game and take legislators out of the picture. They should not be allowed to use the topic of insurance to gain votes for re-election – and if this can be accomplished, then Citizens will return to a market of last resort and the problem would be fixed.