

Weathering the Next Storm: Insurance Industry Perspectives on Florida Law



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RECENT LEGISLATIVE DEVELOPMENTS IN FLORIDA

The legislation continues a trend toward replacing risk-based, pre-event funding with a system supported by post-event funding mechanisms.

In early 2007, Florida legislators passed a historic bill with massive implications for insurers and reinsurers. It's fairly straightforward to understand the bill's impact on companies that provide property insurance to Florida homeowners and businesses. The implications for insurers and reinsurers in other states or the potential impact on other lines of coverage are less obvious. In this paper, we discuss the conditions that brought about this groundbreaking legislation and offer our perspectives on its broader implications for the (re)insurance marketplace. We also recommend some immediate actions for companies to take.

The January 2007 special session of the Florida state legislature was focused on providing rate relief for property owners in the state. The resulting Hurricane Preparedness and Property Insurance Act (in addition to subsequent legislative actions) alters the property insurance landscape in Florida in three significant ways:

- The legislation accelerates the trend toward risk socialization in the state through the expansion of the Florida Hurricane Catastrophe Fund (FHCF) reinsurance and the increased reach of Citizens Property Insurance Corporation, the state's homeowners insurance safety net.

- The legislation continues a trend toward replacing risk-based, pre-event funding with a system supported by post-event funding mechanisms.

- Additional regulatory requirements and restrictions on insurance companies operating in Florida will make it more difficult for them to conduct business.

IMPLICATIONS FOR CITIZENS PROPERTY INSURANCE CORPORATION

The act has both short- and long-term implications for Citizens' historical mission as Florida's insurer of last resort. Citizens is already the largest homeowners carrier in the state. The act virtually ensures growth for Citizens by making it easier for them to "compete" with the private insurance market through lower-than-market rates and surplus lower than private insurer requirements. Additional changes to Citizens are provided below.

- Citizens will no longer be required to offer "noncompetitive" rates.

- Recent rate increases will be rescinded and proposed rate increases canceled.

- Eligibility standards will be altered, effectively making it easier to become (and remain) a Citizens policyholder.

- Citizens will be authorized to write commercial coverage statewide, beginning with the assumption of the policies formerly written by the Property and Casualty Joint Underwriting Association.

- Citizens will be authorized to write multi-peril policies in high-risk zones.

To the extent that Citizens' rates are below those offered by the private market, the unfunded risk is socialized and will be spread to all policyholders within the state. (See page 7 "Federal Solution," for an in-depth discussion of this issue.)

IMPLICATIONS FOR THE FHCF

The amount of reinsurance available through the FHCF has increased significantly. Participating insurers have been given the option to expand their coverage into layers above and/or below the "mandatory" layer previously offered. The aggregate amount of FHCF reinsurance limit is expected to increase from approximately \$16 billion to as much as \$28 billion or more. (The total amount of reinsurance will depend on individual companies' reinsurance

As with Citizens, the expansion of FHCF reinsurance further socializes catastrophe risk to all policyholders within the state.

purchasing decisions.) The optional coverage layers above the mandatory layer are priced very competitively and are expected to be purchased by most companies, while the optional coverage layers below the mandatory layer are less competitively priced.

As with Citizens, the expansion of FHCF reinsurance further socializes catastrophe risk to all policyholders within the state.

For more detail on the specific changes, please reference our prior correspondence titles: “Key Changes in Florida (Re)Insurance Legislation.”

POST-EVENT FUNDING

Private market (re)insurance companies price policies based on an evaluation of the specific risk of the underlying exposure. Companies are structured with a surplus base in order to cushion the financial impact of adverse loss experience. Rating agencies and insurance regulators further discipline the risk management process. The expansion of Citizens and the FHCF, which are not as bound to these controls, displaces private market insurance and reinsurance.

Like Citizens, the FHCF is charging premiums below the level that private capital providers consider adequate to support the underwritten risk. Nor is it backed by surplus consistent with its aggregate level of exposure. In the event of adverse loss experience, the FHCF will also rely on post-event funding mechanisms to pay contractual liabilities. More specifically, liabilities will be funded through assessments on insurance companies and through the issuance of debt (where the debt is backed by future assessments).

Towers Perrin recently prepared a study on behalf of the Associated Industries of Florida (AIF), a Florida business association that examines how premium savings from new legislation compare to potential consumer costs over time, which is available on [towersperrin.com](http://www.towersperrin.com/reinsurance/florida) (<http://www.towersperrin.com/reinsurance/florida>).

INCREASED REGULATORY REQUIREMENTS FOR PRIMARY COMPANIES

The Florida law will increase regulatory requirements and restrictions for primary companies operating in the state. These changes will make it difficult to execute a profitable business plan and raise the cost of operating in the state, potentially forcing additional private capital out of the state. Some examples include:

- making the “presumed factor” filing and the subsequent true-up filing (where the presumed savings from FHCF reinsurance is incorporated into the primary policy rates)
- suspending the option for insurers to appeal disapproved rate filings via arbitration
- requiring certification by the CEO, CFO or chief actuary that savings have been fully passed through to consumers
- prohibition of “excess profits” over a 10-year period.

HOW DID IT COME TO THIS?

At the end of the day, a political solution was reached in Florida.

These changes in Florida did not happen in a vacuum. There were several critical conditions in place that set the process in motion. Key contributing factors are described below.

POOR INDUSTRY IMAGE

The insurance industry is viewed as one of the least trusted industries in the economy. Other industries that share this honor include big oil, utilities, big pharmaceuticals, airlines and Wall Street. The potential for volatile pricing levels as well as a general misunderstanding of how insurance is priced contributes to mistrust by consumers.

This is an important factor. It has been shown that the public's appetite for a government solution to an industry problem is directly related to the level of trust in that industry. In this case, Florida residents were willing to entertain government intervention in the private marketplace.

INSURANCE AND REINSURANCE INTERESTS NOT ALIGNED

In the battle for public opinion, the industry was further handicapped by the misaligned interests of insurers and reinsurers. The two groups lacked a strong, unified message. The disconnect between insurers and reinsurers is regulatory — primary insurance have regulated rates while reinsurance rates have no regulatory restrictions. So, as reinsurance rates climbed, primary insurers were unable to fully incorporate these costs into their rates. This, combined with the lack of insurance availability, made primary insurers much more open to the idea of an expanded FHCF, while the reinsurance industry was firmly against the expansion.

NAVIGATING AN UNSTABLE MARKETPLACE

It has become increasingly difficult for Florida homeowners to obtain coverage and, even when it's available, it's not necessarily affordable. The affordability issues have been growing as rates for homeowners policies have steadily risen, particularly following the 2004 and 2005 wind seasons. As private capital left the state, availability concerns increased, and Floridians looked to the government to address the insurance market's instability.

GOVERNMENT INSURANCE ECONOMICS

The insurance industry will always be vulnerable to government involvement because of the low barriers to entry, particularly for government entities that have different surplus needs and solvency issues. Catastrophe insurance can be particularly enticing to the public sector because the potential costs are uncertain and the contingent liability is not reflected or "accounted for" anywhere in a public entity's budget or plans.

POLITICS BEAT ECONOMICS

At the end of the day, a political solution was reached in Florida. Floridians, anxious for affordable, available coverage they could not get from the commercial market, demanded public-sector solutions. Politicians made promises during the 2006 election cycle, and they were determined to deliver in one way or another. It was politics, not the hard economics of catastrophe insurance, that shaped the changes in Florida.

DIRECT IMPLICATIONS

With Citizens now planning to write commercial coverage, companies writing commercial property policies may soon be pressured by new competition.

The section on “Summary of Recent Developments” (page 2) provides an overview of the immediate, direct consequences of the changes for companies that write homeowners coverage in Florida, which include:

- Citizens becoming a more competitive force in the marketplace
- increased availability of reinsurance through the FHCF
- increased exposure to assessments as a result of the growing reliance on the post-event funding mechanism
- additional regulatory requirements and restrictions.

There are also direct implications for companies operating in Florida that may not be writing homeowners insurance. With Citizens now planning to write commercial coverage, companies writing commercial property policies may soon be pressured by new competition. Citizens may underwrite commercial exposures at below-private-market rates as they do for homeowners coverage. Additionally, the assessment formula for post-event funding does not spare most other lines of business. In fact, Citizens’ assessment base has been expanded to cover all property and casualty written premium with the exception of workers compensation, accident and health, medical malpractice, crop and flood insurance. This assessment base is the same as the base for the FHCF, with the exception of workers compensation coverage, which is not included in the base for the FHCF.

SECONDARY IMPLICATIONS

The recent changes in Florida magnify the potential liquidity crisis insurance companies could face in the event of an extreme hurricane.

ASSESSMENT PROCESS AND ASSOCIATED RISKS

For the Florida Insurance Guaranty Association (FIGA) and for the Citizens “regular” assessment, companies need to pay immediate assessment amounts due within 30 days. After this period, they have the ability to collect assessments from policyholders as policies renew. For assessments that support post-event bonds, the insurance companies act as collection agents, attaching an additional charge to the policy premiums upon issuance. There is a timing cost to immediate assessments because of the lag in obtaining reimbursement. Other potential risks associated with this collection system are not well defined, as the system has not been fully put to the test.

FHCF CREDIT RISK

The expanded reinsurance coverage offered by the FHCF increases the potential deficit in the event of a severe hurricane. To cover the deficit and maintain liquidity, the FHCF will need to issue bonds backed by future assessments. There is significant execution risk with this process, and a severe hurricane event will strain this post-event funding mechanism. As a result, companies due recoveries from their FHCF reinsurance will have some credit risk, although the magnitude of the risk is not clear at this time. Subsequent to the recent legislation, A.M. Best has increased its credit risk factor on FHCF recoverables, and Fitch has downgraded its rating on existing FHCF bonds.

Further, in the event of a severe hurricane, there are three Florida state entities that would potentially need to tap the financial markets for post-event funding: FHCF, Citizens and FIGA. The contractual obligations for FIGA and Citizens are directly to Florida policyholders, while contractual obligations for the FHCF are to the participating insurance companies. If there were any prioritization for bond issuance, it would be reasonable to assume that the state might be partial to entities with direct obligations to policyholders (Citizens and FIGA) over the entity with obligations to insurance companies (FHCF).

When evaluating potential credit risk, one must also consider the full magnitude of post-event funding required from these three entities. Our analysis showed the following potential post-event funding amounts:

Hurricane Return Period	Required Post-Event Funding (in billions)
1 in 20	\$ 9.9
1 in 30	14.6
1 in 50	24.1
1 in 70	31.4
1 in 85	34.5
1 in 100	37.4
1 in 250	54.2

To provide some context for these amounts, the largest state/municipal bond ever offered was for approximately \$12.3 billion (the Economic Recovery bonds offered

by California in 2004). As another point of reference, the total amount of non-life private market catastrophe bond placements in 2006 was approximately \$6 billion.

LIQUIDITY RISK

To some extent, companies always face liquidity challenges in the wake of a large catastrophe. Significant direct policy obligations are due, and reinsurance recoveries need to be evaluated within a short time frame. However, the recent changes in Florida magnify the potential liquidity crisis insurance companies could face in the event of an extreme hurricane.

First, as we’ve mentioned, any recovery issues from the FHCF would put stress on an insurer’s liquidity position. Second, immediate assessments due from FIGA and Citizens would result in payments due in a short time frame. These assessments could be as much as 10% of the insurer’s Citizens assessment base and 2% of its FIGA assessment base (both of which are calculated based on the prior-year written premium in the state). Third, if Citizens issues bonds that are not sold within 30 days, it can forcibly place these bonds with private insurers in the state. Insurers would be required to purchase a proportionate amount of the unsold bonds, based on the insurers’ assessment base. If unmarketable bonds were forced on insurers, the result would likely be to introduce both a liquidity strain and a surplus hit to companies.

The property catastrophe market in several other states is experiencing many of the same critical conditions, particularly wind-exposed regions along the Gulf Coast, Mid-Atlantic states and the Northeast.

REINSURANCE CAPACITY

To the benefit of direct insurers, the expansion of the FHCF adds significant reinsurance capacity to the Florida property market.

It can be argued that the availability and affordability crisis with regard to reinsurance was a result of insufficient reinsurance capacity, particularly for the 2006 wind season. After the significant hurricane losses in 2004 and 2005, followed by significant upward revisions to industry catastrophe models, the estimated catastrophe exposure in Florida surpassed the available capacity. The market impact from the increase in demand worked as expected: Prices moved up and additional supply was attracted. The additional supply came in the form of both traditional reinsurance as well as alternative risk transfer mechanisms such as reinsurance sidecars and catastrophe bonds. But sufficient supply did not arrive in time to prevent capacity shortages and significant price spikes for the 2006 season.

The expansion of the FHCF immediately closed any remaining capacity gap. The reinsurance industry, combined with new financial players in the risk transfer market, moved to fill a capacity shortage relatively quickly. But in the short run, one could argue that it was not quick enough. With these new alternative risk transfer mechanisms now tested, capacity will likely move at an even faster speed should such an imbalance in a reinsurance market occur

again. In the long run, this should prove to be a positive development to reinsurance buyers by adding a source of stability to the market.

PRIVATE MARKET REINSURANCE PRICING

Since the reinsurance available through the FHCF is incomplete, companies still need to consider the private market for wrap-around coverages such as the layers above and below the FHCF, co-participation in the FHCF layers, and second-event covers.

As discussed, the increase in the FHCF capacity represents a sudden and extreme shift in the supply/demand equation for private market catastrophe reinsurance. Pricing was already beginning to soften, and the legislation has helped accelerate this process. The market is experiencing downward pricing pressure on the remaining private market placements as reinsurance capacity is underutilized and redeployed.

This benefit extends beyond Florida. There is downward pricing pressure on regional and national catastrophe programs as a result of redeployed capital. This is true even in situations where a catastrophe reinsurance program does not include any Florida exposure.

This benefit also extends beyond the property catastrophe reinsurance market. There are pressures to redeploy reinsurer capital away from the property catastrophe market into entirely different lines of business. Of course, the reinsurance market views the loss of a significant portion of a large market to public reinsurance as a negative development.

IMPLICATIONS FOR OTHER STATES

An important question is whether other states will pursue a strategy similar to Florida's. The property catastrophe market in several other states is experiencing many of the same critical conditions. This is particularly true for wind-exposed regions along the Gulf Coast, Mid-Atlantic states and the Northeast. States with some level of dialogue on the topic include Mississippi, Louisiana, Alabama, Texas, South Carolina, New Jersey, New York, Connecticut, Missouri and California. If regulators and politicians in these states view Florida's changes as a success, they may move in the same direction.

It is important to recognize that the (re)insurance industry is not speaking with one voice regarding further government involvement in catastrophe risk. An organization named "ProtectingAmerica.org," partially supported by a few major primary companies, is actively lobbying for the expansion of government catastrophe funds. This organization is pushing for other states to replicate the general structure of the FHCF and is also pushing for the creation of a federal catastrophe fund. On the other hand, many major primary companies are opposed to any government solution. Furthermore, the Reinsurance Association of America is attempting to communicate the reasons why government catastrophe funds might not be the right approach.

As coastal states continue to gain population and political clout relative to the balance of the nation, the pressure for a federal solution is likely to grow.

FEDERAL SOLUTION

Should the federal government play a role in the property catastrophe reinsurance market? Florida's socialization of catastrophe risk has forced discussion in both houses of Congress. One proposal would create a federal reinsurance fund that could be accessed by catastrophe funds at the state level, such as the FHCF.

Many would argue that Florida is responding to a significant morale hazard: The state is operating under the assumption that, if the insurance system it has created were to collapse, a bailout would be forthcoming from the federal government. A few of the architects of the Florida legislation have openly acknowledged this point.

The risk of the federal government creating a moral hazard in the financial services industry is not without precedent. The savings and loan (S&L) crisis was largely a result of the explicit backing of bank deposits through the FDIC. S&Ls were put in a "heads I win, tails you lose" situation. They were able to accumulate deposits because of the FDIC insurance and then extend loans to high-risk projects (e.g., speculative commercial real estate development). If the projects were successful, the S&Ls could profit handsomely ("heads

I win"). If the projects failed, the S&L could hand the losses over to the American taxpayer by means of the FDIC insurance ("tails you lose"). Some would argue that the implicit backing by the federal government of Fannie Mae and Freddie Mac is creating a similar exposure for taxpayers.

Is the situation in Florida different? If the wind does not blow, then Florida policyholders benefit by means of insurance policies priced below their proper risk-based rate ("heads I win"). If the wind does blow and the post-event funding mechanism fails, the federal government might step in ("tails you lose").

Historically, the role of the federal government after natural disasters has been to provide help with disaster assistance, infrastructure repair and subsidized loans. The federal government reaction after Hurricane Katrina expanded beyond this, particularly when it went beyond its contractual obligations with respect to federal flood insurance.

As coastal states continue to gain population and political clout relative to the balance of the nation, the pressure for a federal solution is likely to grow. The state of Florida has already exhibited an unwillingness to pay an aggregate premium level consistent with its exposure to loss. One of the goals of federal reinsurance may likely

be a further subsidization of high-risk states by low-risk states.

IMPLICATIONS FOR OTHER COVERAGES

Will risk socialization spread to other lines of coverage? This is another secondary effect that should be considered.

Affordability and availability issues are not limited to property insurance. The medical malpractice line of business, for example, has had periods of severe market instability and deficiency. In response, Pennsylvania created the MCARE fund to provide excess limits of coverage to health care providers. As in Florida, premiums diverged from the actuarially determined risk-based amount.

Today, there is widespread dissatisfaction with the current level of medical malpractice rates in Florida. The rhetoric is heating up, and the state is considering mandatory premium rollbacks. If such measures were to drive private capital out of the marketplace, could the state be heading toward risk socialization in the medical malpractice line of business?

The perceived level of success in Florida will greatly influence the potential spread of risk socialization into other states and other lines of business.

PUBLIC POLICY

The socialization of insurance risk has significant public policy implications. To begin, the post-event funding mechanism established in Florida has significant subsidization issues within the state. The benefits derived from below-market-price reinsurance and suppressed premiums for Citizens are disproportionately greater for those living in the highest risk areas. The post-event funding mechanism (based on assessments on statewide premium) spreads the costs much more evenly to all policyholders throughout the state. As a result, Floridians living in high-risk areas are benefiting at the expense of others.

Economically, this leads to a misallocation of resources. Because the costs of development in high-risk areas are not properly internalized, the market will respond to the below-market price by creating an oversupply as compared to the true economic equilibrium. In other words, there will be overdevelopment in high-risk zones.

This overdevelopment also demonstrates how insurance subsidization is not a zero-sum game. With more development in high-risk areas, the cost of a hurricane event will be higher than it otherwise would have been. So not only is the cost of the hurricane risk shifted, but the sum total has also increased.

These are issues that should be understood in the discussion of the role of the federal government. Who should pay for the risk is a fundamental question. Should the insurance premium for a particular property reflect its own specific level of risk, or should there be subsidization of costs through social mechanisms?

CONCLUSION

When viewed in a long-run context, these solutions raise more questions than they answer.

The legislative changes in Florida represent a significant extension of the role of state government in the property (re)insurance market. The expansion of Citizens provides an immediate solution to some of the availability issues. The expansion of below-market-price catastrophe reinsurance from the FHCF provides an immediate solution to some of the affordability issues. But when viewed in a long-run context, these solutions raise more questions than they answer:

- Were the reinsurance capacity issues in Florida a short-term phenomenon or a long-term deficiency?
- Are the changes to the Florida property market easily reversible?
- Do these immediate solutions to the availability/affordability problems through risk socialization outweigh the potential economic costs due to misallocated resources?
- Do the market conditions in other states sufficiently resemble those in Florida to the point that similar solutions might be implemented?
- What future role will the federal government play in the property catastrophe market?
- Who should pay for the cost of building and living in a high-risk zone?

For members of the overall (re)insurance community, these are important questions to consider. But aside from the theoretical issues, what should companies be focusing on right now?

Towers Perrin offers these recommendations:

- Review your Florida strategy regarding property exposure, line-of-business distribution and the outlook on future profitability.
- Evaluate your current exposure to state assessments, forced-placed bonds and FHCF credit risk.
- Evaluate your property exposure in other states that may be considering legislative changes that would impact the private market.
- Evaluate your aggregate catastrophe exposure and how you are managing this risk, including mitigation through private and expanded public reinsurance.
- Continue to monitor the developments in Florida as the situation continues to evolve.

Towers Perrin can help you evaluate and manage through the complex issues discussed in this update — for more information, please contact:

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