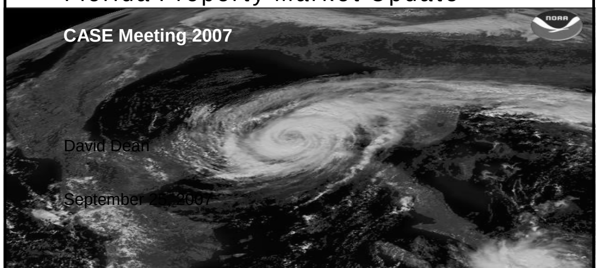
TOWERS PERRIN
TILLINGHAST

Florida Insurance Legislation

# Florida Property Market Update



**CASE Meeting 2007**

David Dean

September 25, 2007

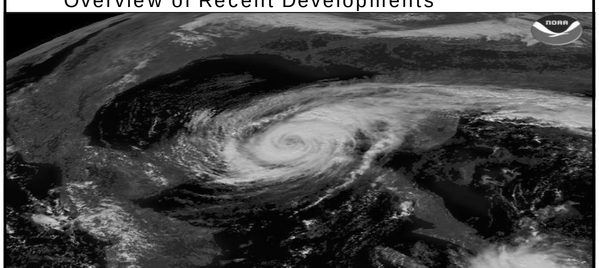


## Today's agenda

- Overview of Developments
- Background – How Did We Get Here?
- Some Details
- Tillinghast Analysis
- Broader Implications and Things To Watch
- Questions and Discussion

## Overview of Recent Developments



## "Pray Now, Pay Later"

- Extraordinary expansion of role of state in property insurance and reinsurance markets in Florida
  - Expansion of the Florida Hurricane Cat Fund (FHCF)
  - Changes to Citizen's historical mission: A "Competitive" Citizens
- Movement further away from risk-based pre-event funding to post-event funding
  - Dramatically increases exposure of Florida residents (not just homeowners) to post-Cat assessments
  - Threatens State of Florida's credit rating
- Additional regulatory requirements and restrictions for primary companies
  - Disincentives for insurers to offer policies in Florida

## But that's not all . . .

"The insurance industry and lobby are relentless in their pursuit of higher rates. And I think it's just as important for those of us who serve the people of this state to be relentless as well."

Florida Republican Governor Charlie Crist

## Background – How did we get here?

## There were several key ingredients in place to fuel the storm



## Historical context, or What really led to H.B. 1a (Hurricane Preparedness and Property Insurance Bill)?

- Problems Began in 1992 with Hurricane Andrew
  - Continuous escalation in home and commercial property insurance prices; $21.6B insured losses ($2005); 700K+ claims
- Issue Ignited in 2004: Charlie, Frances, Ivan & Jeanne
  - $23B in insured catastrophe losses; 2.3 million claims
  - Large rate increases requested; Wind deductibles triggered
  - 100,000+ homeowners non-renewals issued
  - Channeling of policies into expensive market of last resort
- Issue Exploded in 2005: Dennis, Katrina, Wilma
  - $12B in insured losses; 1.2 million claims
  - More large rate requests
  - 125,000+ non-renewals
  - Several insurers announce moratoria on new policies
  - Sharply higher commercial property prices
  - Failure of Poe Financial Group



## Ingredient #1: Poor reputation of industry

- A Google search of "Least Trusted Businesses . . . "

5. Airlines/Travel
4. Utilities
3. Brokerage/Wall Street
**2. INSURANCE**
1. Oil & Gas



## Ingredient #2: Marketplace volatility

- Insurers respond rationally
  - Scale back overall exposure based on what they can fund
  - Increase rates to actuarially sound levels
- Equity and affordability issues:
  - Significant rate increases post 2004 and 2005 seasons magnified affordability issues
  - Reduction of coverage and availability underline the problem
- Causes pressure to move away from risk-based premiums



## Ingredient #3: Interests of insurance and reinsurance industries not aligned

- Squeeze caused by regulated primary rates, unregulated reinsurance rates
- Lack of coherent position on how to approach natural cat exposure in the U.S.
  - Some support state's expansion, others do not
- Insurance and reinsurance industry misjudged populist groundswell
  - Did not exert leadership on the issue
  - And politicians filled the void



## Ingredient #4: The economics of government insurance

- Low barriers to entry
- Premiums become more divorced from actuarially sound, risk-based analysis
  - Known revenue upfront
  - Unknown costs later
- "Free" contingent capital of state
  - Treating state bonding capacity as a free good

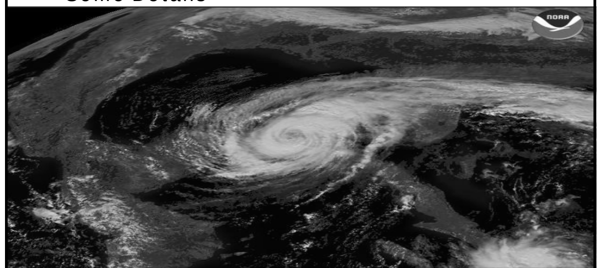
## Ingredient #5: Politics

**The importance of politics cannot be underestimated**

- On reinsurance rates:
  - "One could argue it is price gouging" (State Insurance Commissioner, Kevin McCarty)
  - "I would call it greedy." (consumer advocate, Robert Hunter)
- "The insurance industry this past year has enjoyed a $60B profit. $60 billion. And I've seen estimates where $3B of that money has been made on the backs of Floridians. And they're tired of it. And so am I. Nobody got a refund when we didn't have a storm." Governor Crist)
- Idea of creating a commission to tackle the problem . . . which could include doing away with "*monopoly advantages* afforded the insurance industry." (Democratic Sen. Bill Nelson)
- "I'm not so concerned about the ingredients of the cake, I just want to make sure that we have the cake that offers lower rates to the people . . ." (Governor Crist)

## Some Details




## Changes to Citizens

- Lowers rates
- Not required to offer "non-competitive" rates
- Citizens can expand into non-wind coastal business
- Rescinded recent rate increases; rates in effect as of 12/31/06 to stay in place for all of 2007
- Loosen eligibility requirements
  - Also easier to stay in Citizens
- Authorized to write commercial coverage statewide
- Take on policies formerly written by Property and Casualty Joint Underwriting Association
- Citizens may write multi-peril policies in high risk zone
- Assessment base expanded (P&C lines excl. WC, A&H, MM, Crop, Flood)

Citizens is now the largest personal lines property insurer in the state of Florida

## Changes to the FHCF

- Expansion of Limit
- "Mandatory Cover" approx. $16B XS $6B (similar to 2006)
- Two new layers below mandatory FHCF layer
  - Temporary Emergency Additional Coverage Option ("TEACO"); $1B to $3B
  - Up to $10M for Limited Apportionment Companies in Insurance Capital Build-up Incentive Program
- Additional layers of cover above mandatory FHCF layer
  - Temporary Increase in Coverage Limits ("TICL"): Twelve options ($1B to $12B) of coverage above mandatory FHCF layer

## Additional changes to the FHCF

- Eliminates "rapid cash build-up factor" (25% load in rates)
- Authorizes the SBA to purchase capital market instruments to back FHCF obligations (cat bonds, ILWs, etc)
- Changes effective for 2007 wind season
  - Scheduled to sunset in three years

## Regulatory requirements and restrictions

- Insurers to provide notices of discounts, credits, rate differentials, and deductible reductions for mitigation measures
- Suspends the option for insurers to appeal disapproved rate filings via arbitration until 1/1/2009
- Requires notice of non-renewal to consumers and OIR at least 100 days prior to renewal date or June 1 (whichever date is earlier)
- 90 days to pay or deny claim
- CEO/CFO/Chief Actuary certification that savings from Act passed through to consumers
- Prohibits "excess insurer profits" over 10 year period
- If company writes auto in FL and HO in another state, must write HO in FL effective 1/1/08

## What does this mean?

- Continued growth of Citizens
  - Current liquidity of $9 billion, including line of credit
  - Current estimate of exposures, as of March 2007: $434 billion
- Expansion of FHCF
  - Crowding out of private capital from the FL market
  - Isolation of Florida from global capital to underwrite risk
  - Downward pricing pressure in private reinsurance market
  - Decreased demand for new sources of capital (e.g. sidecars, Cat bonds)




## What does this mean?

- Absence of diversification
  - Florida now operates as a monoline, single state, single risk company
- Serious concentration of risk
  - Cut off access to global capital markets
  - Citizens market share is concentrated in riskiest areas
  - FHCF is Citizen's sole reinsurer; FHCF doesn't access retrocessional market
- Citizens' rates are not adequate
- Citizens & FHCF are thinly capitalized
- Losses are substantially funded via post-event assessment
- Plants seeds of animosity between non-coastal & coastal dwellers (within state and with non-coastal states)
  - Largest beneficiaries are residents of southeast coast
- Plan will alienate business community (liability lines assessed)
- Homeowners insurance has been converted into a regressive income and wealth transfer mechanism




## What does this mean? (cont'd)

- Policy discussion "elevated" to a food fight of 2nd-graders in the school cafeteria
  - Name calling and posturing limit opportunities for constructive dialogue
  - Expert knowledge in all domains is devalued (actuarial science, economics, finance, statistics, meteorology – all are considered to be arrayed against Florida consumers)
- For insurers, political risk in Florida is greater than catastrophe risk

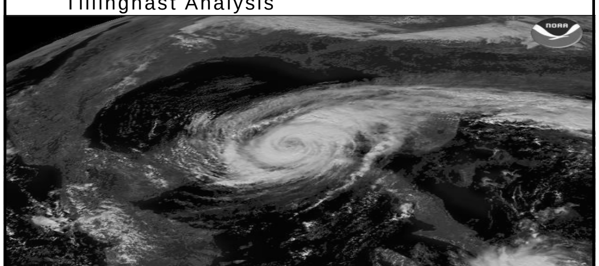



## Have the intended effects been achieved?

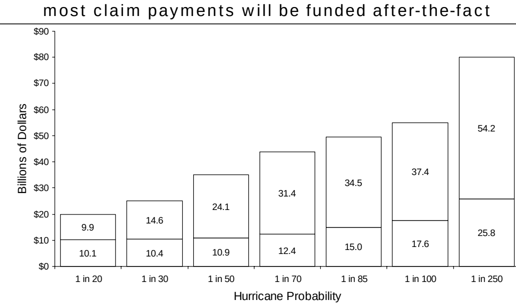
- Average rate cuts of 24% promised
  - Preliminary data shows average rate cut around 12%
    - — Backpedaling from Robert Hunter, OIR consultant, on what is covered
- Insurers dramatically scaling back exposures
  - Allstate non-renewals 200,000 policies
  - Nationwide: 78,000
  - State Farm: 50,000
  - USAA: 27,000




## Tillinghast Analysis

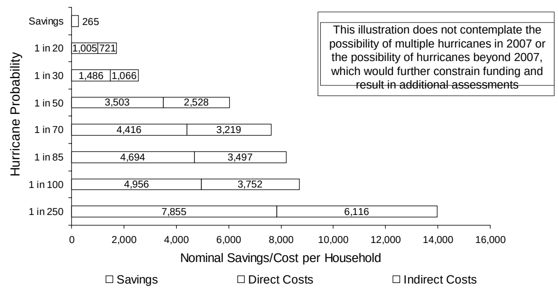


## In the event of an active hurricane season in 2007, most claim payments will be funded after-the-fact




Notes: Pre-event funding includes funds available to Citizens, FHCF, and private carriers, plus contingent funding available through private reinsurance to pay claims in 2007. Post-event funding is on a present-value basis and does not include cumulative financing costs. Probabilities are expressed as "odds of a single storm of this magnitude or greater happening in the 2007 season".

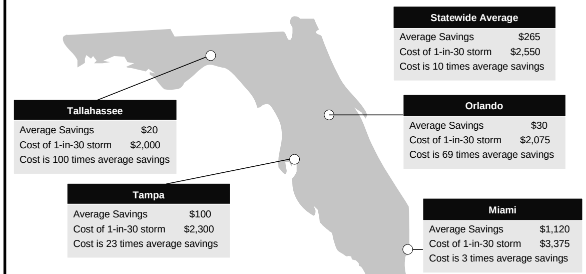
## Potential long-term costs of 2007 hurricanes could overshadow 2007 premium savings for consumers




Notes: Assumed average homeowners premium per household is $1,300 in 2007. Savings for 2007 premiums reflects 24.3% savings on hurricane costs, which are assumed to be 63% of total premiums. These savings are based on the statewide OIR estimate. Actual savings may be less. Direct costs include assessments paid by policyholders on homeowners and personal auto premiums. Indirect costs include assessments on commercial lines passed onto consumers through higher prices. Amounts expressed here are the nominal costs, or the total cost of borrowing including financing charges paid over the term of the bond.



## Savings for typical policyholders are highest in coastal areas, but exposure to the nominal cost of future assessments and surcharges is not proportionate to savings...

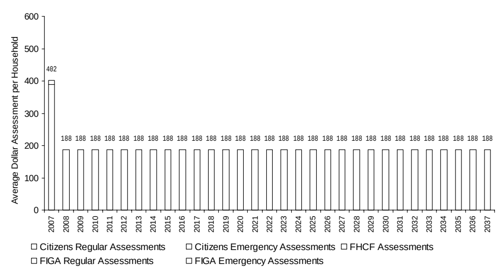



...meaning that policyholders in lower risk areas would subsidize high-risk area policyholders if a major event were to occur.

Note: Cost includes direct assessments and indirect costs to repay bond principal and financing charges. This illustration assumes that homeowners rates in Miami, Orlando, Tallahassee and Tampa are 180%, 53%, 46% and 76% of statewide average premiums, respectively.



## Annual assessments per average household would extend out 30 years under various scenarios (here, a 1 in 50 storm in 2007)

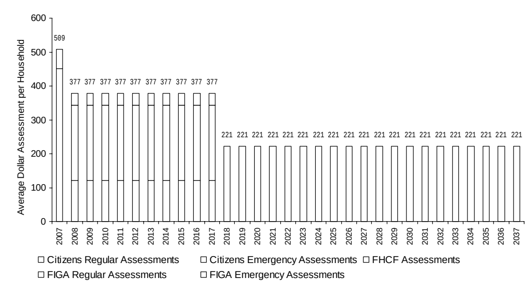



This illustration does not contemplate the possibility of multiple hurricanes in 2007 or the possibility of hurricanes beyond 2007, which would further constrain funding and result in additional assessments

Note: Number of households is based on 2007 households and is not adjusted for future population growth.



## Annual assessments per average household would extend out 30 years under various scenarios (here, a 1 in 100 storm in 2007)

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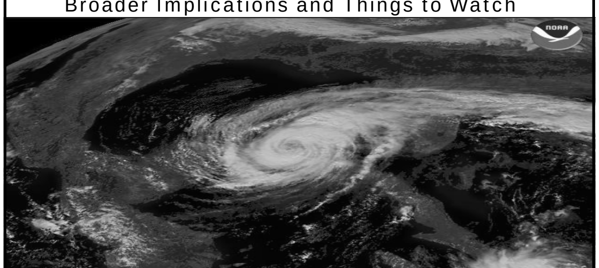
## Broader Implications and Things to Watch



## Broader implications

- Will expansion of role of state government be limited to Florida?
  - PCIAA describes a “wave of punitive and anti-competitive legislative and regulatory initiatives in state capitals from Austin to Boston”
  - Politicians in many coastal states facing similar pressures as FL: MS, LA, AL, TX, CT, NJ, NY, MO, CA
  - Interests of primary insurers and reinsurers remain misaligned
    - — “Protecting America” (organization of primary companies looking to replicate FHCF in other states) vs. RAA “Government Cat Funds an Idea That’s Bad for America’s Insureds”
- How “addictive” are below market rates?
- Further abandonment of actuarially sound, non-subsidized pricing

## Why stop with property insurance?

- Medical malpractice crisis in Florida
  - FL docs pay one of the highest med mal rates in country
  - "If in fact the rates are shown not to go down, even though we have a (lawsuit damages) cap, it has to make you wonder what's going on." (Governor Crist)
  - "If the industry hasn't recognized it's a new day and doctors should get a break on their premiums too, that would be very disconcerting to me.“ (Governor Crist)
  - Former state consumer advocate request of regulators to roll back premiums by 40 percent: “. . . we are seeing far greater reduction of costs than are being passed on.“
  - Consumer advocates want insurance companies to shorten the historical time frame so new trends are better represented in premium rates




## A federal solution?

- The “Put Option”: Expectations that Federal Government will come to aid in event of catastrophe (significant moral hazard)
- Federal aid after disaster: disaster assistance, infrastructure repair, temporary relief measures, low interest loans, flood insurance. . . . . . .private homeowners???
- Federal Disaster Plan would lead to further disintermediation of reinsurance companies
- Significant questions of subsidization and efficient allocation of resources
- No free lunch: Someone pays




## Pressure builds in Washington

- “We will continue to work together to urge the federal government to create a national catastrophic fund and I know if we work together we can succeed.” (Governor Crist, March legislative session)
- House proposal for states to create their own disaster accounts - like Florida's – and also access a Treasury Department account.
  - Widespread support for reducing HO insurance rates
  - US Reps Ron Klein and Tim Mahoney of Florida, Barney Frank (Financial Services Chairman)
- Senate considering a range of ideas to handle high insurance rates, including regional and national catastrophe funds.




## Is there a way out of this mess?<br>Or, tools to mitigate windstorm exposures

- Legislative solutions
  - Strengthen and rigorously enforce building codes
  - Fortified home programs
  - Incentives to adopt mitigation
  - Forcing communities to consider and take a larger stake in their catastrophe exposure
- Insurance/financing solutions
  - Insurance rates based on sound actuarial principles (risk-based rates that are not government controlled)
  - Disciplined underwriting
  - Removing impediments to capital flows
  - “Coastal Hurricane Zone”?
  - Industry consensus on solutions?

Source: Insurance Information Institute




## How will this story end?

- The big one?
  - Market turmoil
  - Post-event funding obligations kick-in
  - More difficult to move to risk-based pre-event funding formula
  - Accelerate socialization?
  - Frighten other states?
- A quiet period?
  - Could HO rates move upwards towards a risk-based pre-event funding formula if no insurer losses?
  - Will other states view FL changes as attractive?
- A soft landing and slow transition to risk-based premiums?
  - True market forces slowly prevail?




## Questions and Discussion