Florida Property Insurance – The "Citizens" View

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Overview

- What Is Citizens? Why Does It Matter?
- The Evolution of Citizens – Three Vantage Points
  - Market, Structure and Scope
  - Political Perceptions
  - Rate Standards
- The Core Actuarial Question – the Right Capital Load for Citizens
  - Current actuarial framework
  - Sources and costs of capital
  - Role of actuarial estimates and market forces
- Some Public Policy Questions
  - Premium Increases: Rates or Exposure?
  - Should property insurance be “Affordable”? “Budgetable”? Neither?
  - Should Citizens’ rates be subsidized? Implicitly or explicitly?
  - What lines should Citizens write? Where in Florida?
  - Should Citizens be an arm of the government?

What is Citizens and Why Does it Matter?

- Citizens is now the largest property insurer in Florida and the fourth largest in the nation
  - 1.3M policies, $400B in exposure, over $3B premium
  - $15-25B Probable Maximum Loss in 100-year storm (by various models)
  - 25-40% Market Share by various measures
- Citizens has legal claim to vast taxpayer and policyholder money
  - PML exceeds surplus by $20B or more
  - Citizens takes 35% of the FHCF, which has $32B PML in same storms
- Citizens is a direct insurer of nearly all coastal property
  - Residential, Condos, and first $1M of most commercial
  - Over 8,000 appointed agents
  - Massive claims-paying and policy/financial administration machine
- Citizens is steadily drifting toward becoming an arm of the State
  - Board now appointed by top public officials
  - More public control over HR, investments, financing and reinsurance
  - Recent legislation gives direct regulatory control over rates

The Evolution of Citizens: Structure and Scope

Florida Windstorm Underwriting Association

- Created in 1970's as market of last resort for all coastal property
- Perils: Wind only (hurricane and other wind)
- Lines: Residential, commercial habitational, and commercial property
- Rate standards: Actuarially sound (defined by F.S. 627.062)
- Funding: Retained surplus, borrowed funds, and authority to assess all property policies in deficit years
- Tax status: Taxable insurer

FWUA and FRPCJUA were merged by legislative act to form Citizens in 2002 (F.S. 627.351)

CITIZENS PROPERTY INSURANCE CORPORATION

- Created in 1993 as market of last resort for residential property
- Perils: Multi-peril (owners, renters, and unit-owners forms)
- Lines: Residential and commercial habitational
- Rate standards: Non-competitive (defined by a "Top 20" formula)
- Funding: Retained surplus, authority to assess all property policies in deficit years
- Tax status: Federal tax-exempt entity (due to non-competitive nature)

Florida Residential Property & Casualty Joint Underwriting Association

The Evolution of Citizens: Political Perceptions

- 2002 (formation)
  - Consolidate duplicative residual markets
  - Save taxpayers money with tax-exempt status

Put yourself out of business!

- 2003-04
  - Aggressively depopulate with generous takeout bonus program
  - Charge non-competitive (highest) rates to not disrupt voluntary market
  - Limit hiring and infrastructure

Don't just stand there, get back in business!

- 2004-05 (after four hurricanes)
  - Improve customer service and claims response

Don't go broke, charge more and buy reinsurance!

- 2005-06 (after four more hurricanes)
  - Borrow money and levy assessments to replenish capital
  - Charge rates consistent with capital needs of an equivalent private insurer
  - Clean up management – better ethics standards

People can't afford this, charge less despite the assessment risk!

- Summer 2006 (after market meltdown)
  - Residential rates are too high - limit rate increases
  - Commercial-residential and builder's risk affordability crisis – keep writing these lines

Evolution of Citizens: 2007 and Beyond

It's "The People's Company"! Not a "profiteering" private insurer.

- Write it Cheap - residential business at rates well below average annual costs
  - Scheduled 2007 rate increase to cover estimated reinsurance costs canceled
  - Existing actuarial-based rates effective Jan. 1, 2007 rescinded
  - Freeze rates at early 2006 levels until 2009
  - Further reduce rates for theoretical reinsurance savings (presumed factor) and generous wind mitigation credits without revenue offset
- Write it Anywhere - any property line throughout Florida
  - Offer multi-peril residential policies statewide – delete limits on condos
  - Continue to offer builder's risk indefinitely
  - Expand commercial offerings statewide to non-residential classes
- Write it Forever - no eligibility restrictions and few incentives for depopulation
  - Substantial reduction in takeout bonuses for private insurers
  - Consumers can individually decline any takeout offer
  - Those already in Citizens can stay indefinitely
  - Eligibility for anyone whose private market rate is 15% higher than Citizens

Evolution of Citizens: Path of Rate Standards

Period	Residential Multi-Peril	Residential Wind-only	Commercial
Pre-Merger to May 2006 (SB1980)	Non-competitive by "Top 20" formula	Actuarially sound	Actuarially sound AND non-competitive
May 2006 to Jan. 2007 (HB1A)	Actuarially sound including reinsurance cost provision (to 100-year PML) AND non-competitive by Top 20	Actuarially sound including reinsurance cost provision (to 70-year PML) AND non-competitive by Top 20	Actuarially sound including reinsurance cost provision AND non-competitive
Jan. 2007 to May 2007	Frozen at early 2006 levels until Jan. 2008 – then actuarially sound	Frozen at early 2006 levels until Jan. 2008 – then actuarially sound	Actuarially sound
Current	Frozen until Jan. 2009	Frozen until Jan. 2009	Actuarially sound

What's the Actuarially Sound Rate for Citizens? Catastrophe Exposure: Review of Principles

- "Actuarially sound" rates must account for *all costs associated with the transfer of risk* (CAS Statement of Principles)
  - For cat-exposed property, such costs are largely divided into two provisions

Expected Loss Costs: the average annual losses per exposure unit funded by annual premiums

$$\Delta = \frac{x + f + f_R}{1 - v} - 1$$

Cost of Capital: the charge for holding or accessing large amounts of money in excess of that collected in annual premiums; this credit is needed because a catastrophe can occur in any year

Actuarially Sound Rate Change Formula:

x = expected loss ratio

f = fixed overhead expense ratio

f_R = fixed cost of reinsurance (capital) ratio

v = commission, taxes, and profit provision

- *The key actuarial difference between residual and private market insurers is their set of options for obtaining capital*

Rate Standards: What does "All Costs" Mean for a Public Insurer?

- Private insurers fund large losses through
  - Retained surplus - including infusions from parent companies
  - Reinsurance - both private and public [Florida Hurricane Cat Fund]
- Public insurers have two additional funding options
  - Borrow money in debt markets (pre- or post-event)
  - Assess policyholders and taxpayers (post-event)
- How do we calculate the cost of capital for each option?
  - Retained surplus – use a hurdle rate consistent with insurer's capital structure and market's required returns
  - Reinsurance – divide the reinsurance premium into
    - Expected ceded losses – already included in gross expected loss costs – usually done with a catastrophe model
    - Net cost of reinsurance – the remainder is cost of capital and transaction costs
  - Borrowed funds – net interest costs serve as lower bound for capital costs – can be negative particularly if investment income is tax-exempt
  - Assessments – **NO settled actuarial standard** for estimating amount or distributing among classes/territories
- Begs the question: Is the cost of assessment capital zero for rates?

Capital Options and Costs: A Thought Experiment

- AFR Insurance Company writes 100% of the residential property insurance in State F and must fund its obligations to 100-year PML
  - Exposure: $2 Trillion
  - Average annual hurricane losses: $3.5 Billion
  - 100-year Probable Maximum Loss: $47.5 Billion (need $44B of capital)
  - Variable expense ratio (commissions, tax, normal profit) = 20%
  - Fixed expenses = $1 Billion
  - Non-hurricane losses and LAE = $3 Billion
  - Retained surplus = $4 Billion
- Assume AFR has the following options for raising capital:
  - Borrow at net interest rate of 2%
  - Reinsurance at average rate-on-line of 20%
  - Assess 6 million residential property policies for unfunded remainder
- Question: What is the "actuarially sound" annual premium for AFR?
  - Answer: Depends critically on capital structure and cost of taxpayer funds

Capital Structure and Options: Run Some Numbers

- Expected hurricane and non-cat losses and fixed expenses, grossed up for variable expenses
  - ($3.5B + $3B + $1B) / (1-20%) = $9.4B
- Plus cost of capital:
  - Retained capital – assume 5% “risk free” hurdle rate ($4B x 5%) = $200M
    - Why 5% and not more?
  - Net interest costs – assume ability to borrow $10B x 2% = $200M
    - Why did we limit to $10B?
  - Reinsurance costs: $20B x 20% = $4B
    - Why did we limit to $20B?
  - Taxpayers fund remainder: $44B - $4B - $10B - $20B) x 2% = $200M
    - Should return to taxpayers be the same 2% as on debt?
  - Total cost of capital = $200M + $200M + $4B + $200M) = $4.6B
- Gross up cost of capital for variable expenses
  - $4.6B / (1-20%) = $5.7B
- Total actuarially sound annual premium = $9.4B + $5.7B = **$15.1B**

AFR Example: Assumptions

- You may have guessed that AFR is a proxy for the entire Florida residential property market (private and Citizens, all backed by FHCF)
  - AAL and PML numbers are from FHCF 2007 Ratemaking Report
  - Variable and fixed expense ratios from A.M. Best 2006 Aggregates
  - Policy counts and premium volume for 2007 estimated from regulatory data
- Justification for major assumptions:
  - $10B is roughly the largest single municipal debt placement ever – assume this limit on rapid borrowing post-event
  - If FHCF could borrow $10B post-event it would still need $20B to meet its obligations. Assume it can buy that much reinsurance and passes through those costs rather than subsidizes/assesses
  - Assume Citizens buys only FHCF reinsurance and acts as the assessment vehicle for the remaining $10B – it doesn’t matter for our purposes which state entity is tapping the taxpayers
  - Rates of return: Conservative
    - 5% is a risk-free hurdle rate but 70% of the risk capital is in private market
    - 20% average rate-on-line is much lower than in 2006 and reasonable for 2007
    - 2% is reasonable cost of carry – and remember this money must be paid back!

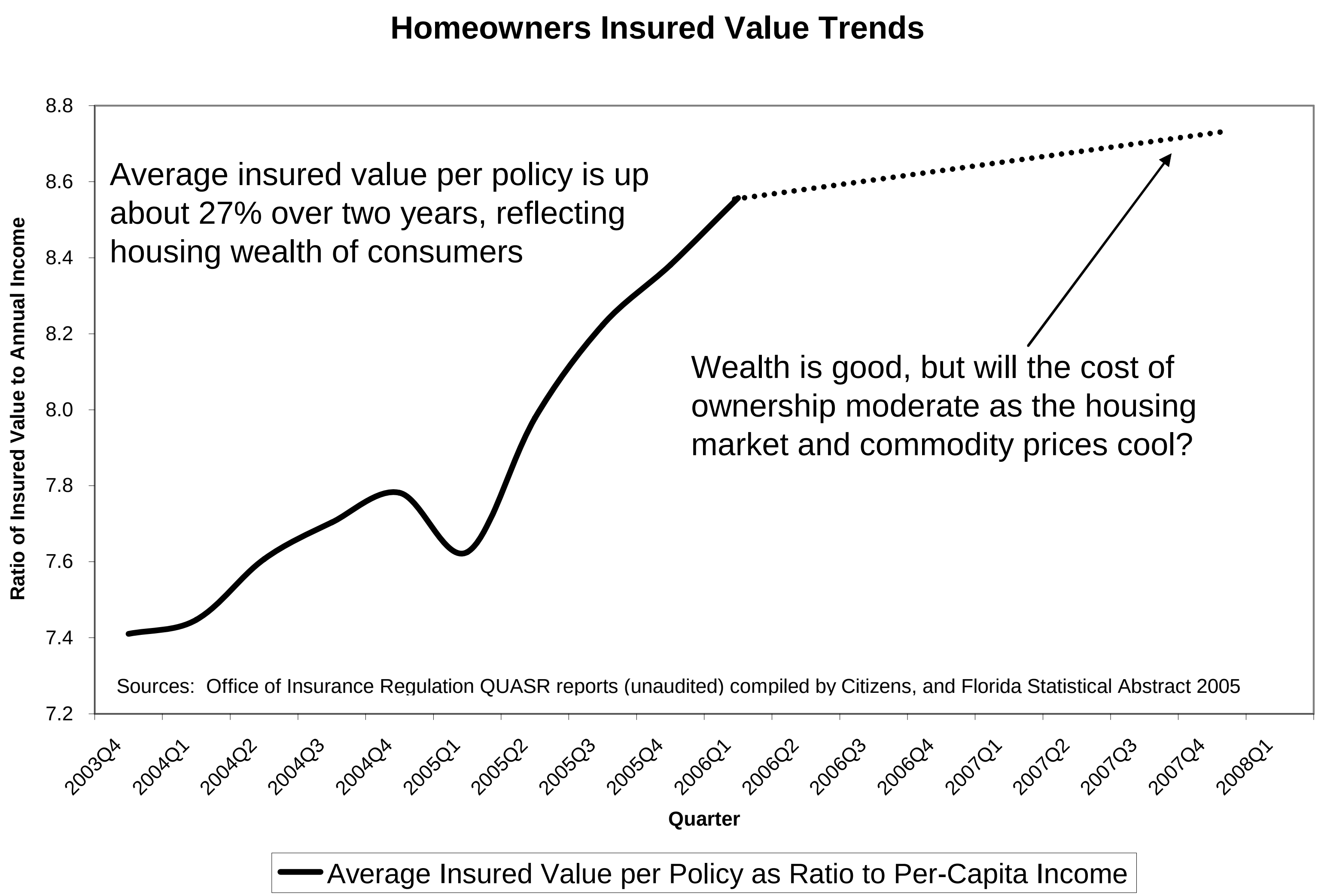
AFR Example: Implications

- Bottom Line: Under very generous assumptions, Florida needs to collect at least $15 Billion in 2007 residential property premium to fund insurance promises in an actuarially sound manner
  - Last year the actual figure was about $8.8 Billion
- Citizens and FHCF together cannot fund obligations without major infusion of debt and taxpayer capital, which has a significant cost that should be recognized in Citizens' direct rates
- Even the costs we have assumed do not protect Florida's balance sheet
  - $10B in new debt will have to be paid back
  - Economic growth and revenue may suffer as taxpayers pay another $10B over time
- Size of assessments after events can be 50% or more of premium
- Hurricane modeling can determine the expected loss cost directly, but also indirectly influences the cost of capital from all other sources
- Ultimately the cost of capital is determined by reinsurance and financial markets – we cannot regulate our way out of the problem, only delay the reckoning

Public Policy Questions: Exposure vs. Rates

- *Point*: About two-thirds of the growth in Florida average policy premiums since 2003 is due to replacement value growth, not rate increases
- *Counterpoint*: It doesn't matter which to the person paying the bill
- *Implication*: The real crisis is the cost of ownership of real estate
  - People are still getting what they pay for with insurance to protect wealth
  - Mortgage escrow includes both insurance and property taxes - which are closely tied to market value and have skyrocketed since 2003
  - But despite the liquidity of home-equity loans, many residents are house-rich and cash-poor through no direct action of their own
  - If houses were cars, it would be like buying a Corolla and opening your garage the next day to find an SUV – with the gas and maintenance bills
- *Solutions*: Wait for the market to turn and incomes to rise, limit property tax growth, allow deletion of optional coverages?

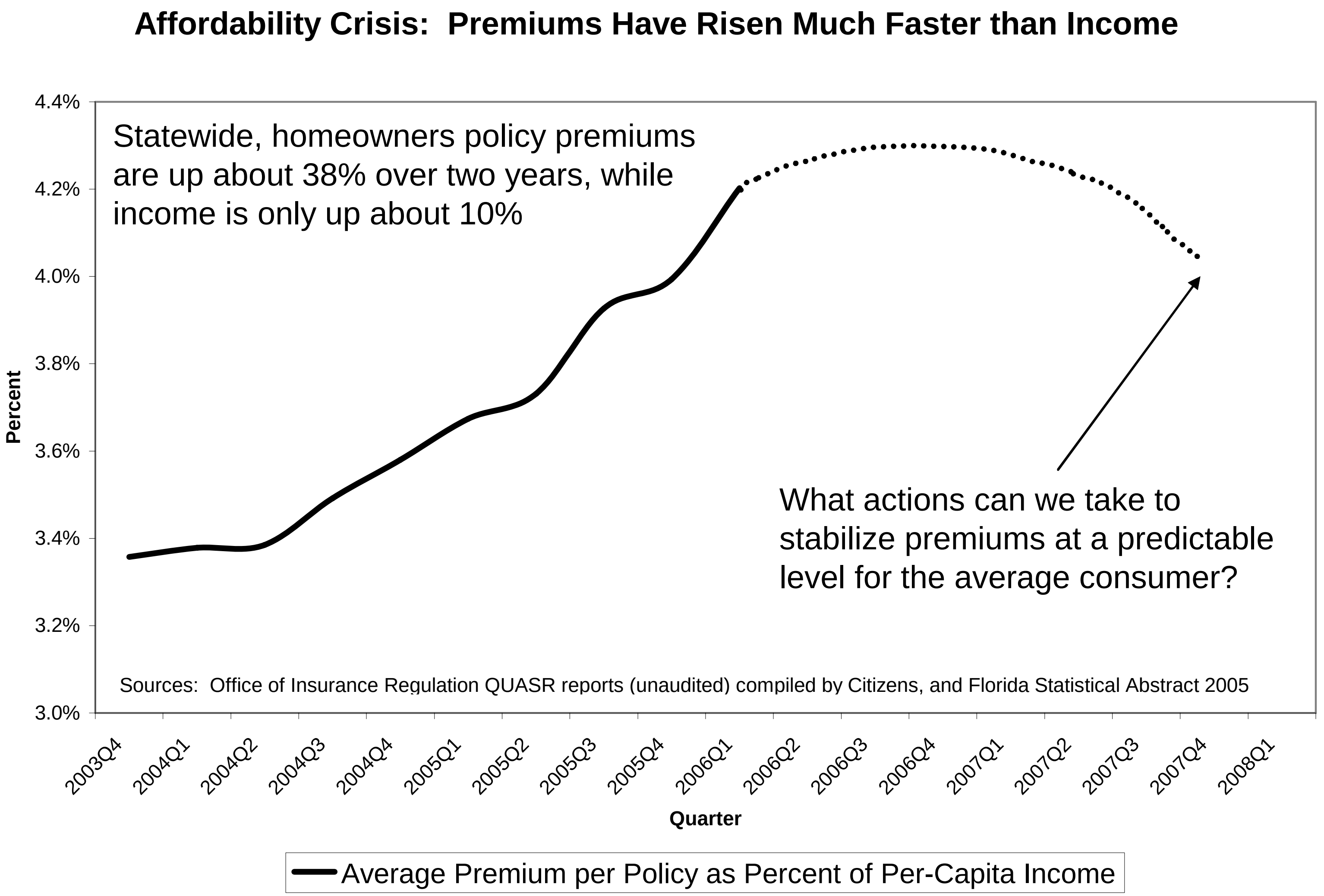
Exposure Growth Trends



Public Policy Questions: Affordability vs. Budgetability

- *Point*: Insurance costs have risen, reflecting exposure, but still make up less than 5% of per-capita income and less than 20% of a typical mortgage escrow payment
- *Counterpoint*: The shock has been disastrous for those on fixed incomes and those near the coast
- *Implication*: The biggest problem is a feeling of “bait and switch” and budgetary uncertainty
  - Many property owners moved or retired years ago with expectations of cheap insurance relative to income
  - A steady rise in rates can be budgeted over time – huge increases, whether from existing company, or when forced into or taken out of Citizens, cannot
  - If we know gas prices will go up 10% per year, we might shop differently when it’s time to buy a car; if they explode 50% in three months we’re stuck in our trucks
- *Solutions*: Flex Rating, annual filings and more consistent regulation – no more “pent up” rate increases in a crisis. FHCF as a stable capital source.

Premium and Income Growth



Public Policy Questions: Rate Subsidies?

- *Point*: Insurance is based on risk pooling, not risk subsidies – the market will work if rates, including those of Citizens, are allowed to reflect costs
- *Counterpoint*: In the larger economic growth picture, the tax and activity base is disproportionately coastal; insurance rates should protect the growth prospects of these areas
- *Implication*: The market difficulty is not subsidies (those are everywhere in public policy), but that they are buried and hard to analyze or debate fairly
  - Inland residents subsidize coastal when territory differentials are capped
  - Private market insureds subsidize Citizens when its rates are held down for years
  - Well-built homes subsidize poor construction when mitigation not fully reflected in rates
- *Solutions*: Develop and charge actuarially sound rates, then use transition plans and explicit programs to encourage mitigation and meet social needs

Public Policy Questions: Citizens' Footprint on Market

- *Point*: Residual markets, especially at subsidized rates, crowd out private capital and lock in shortages for long periods – limit them to lines which are (socially) absolutely necessary. Businesses are particularly sophisticated buyers and can access surplus lines.
- *Counterpoint*: Economic peril just as great if businesses shut down, residency becomes unaffordable, development ceases, customers pay more. Small commercial lines must have a market of last resort.
- *Implication*: Citizens should build its infrastructure around the idea of getting "in and out" of spotty problem markets such as builders' risk and condo associations as necessary.
- *Solutions*: Attractive depopulation programs for commercial lines, rates reflecting market reinsurance costs, an efficient market assistance program for agents?

Public Policy Questions: Governance of Citizens – State-Run, Privatized or Hybrid?

- *Point*: It's an insurance company, let it run like one – efficiently and using private sector best practices and principles. Government meddling paralyzes decision-making and slows down operations.
- *Counterpoint*: Without selective underwriting, normal business rules don't apply. Further, Citizens has both business goals (maximize surplus and manage risk) and social goals (ensure universal coverage at "affordable" rates). The people are the arbiters of social goals.
- Implication: Citizens should get used to having many bosses and develop its human capital and processes around these checks and balances
- Solutions: Governance by appointees with vast private sector expertise, aggressive recruiting of industry veterans, but close supervision by public officials and watchful eyes of media?

Thank You for Listening!

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