

INDUSTRY PERSPECTIVE OF FLORIDA HURRICANE MARKET

STATEMENT OF STEVE GOLDBERG
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TO THE TASK FORCE ON LONG-TERM SOLUTIONS FOR FLORIDA'S
HURRICANE INSURANCE MARKET

AUGUST 24, 2005

GOOD MORNING. MY NAME IS STEVE GOLDBERG. I HAVE BEEN ASKED TO OFFER COMMENTS ON THE INDUSTRY PERSPECTIVE OF THE FLORIDA HURRICANE MARKET. I AM EMPLOYED AS CHIEF ACTUARY OF THE REINSURANCE INTERMEDIARY, BENFIELD. I AM A FELLOW OF THE CASUALTY ACTUARIAL SOCIETY, A MEMBER OF THE AMERICAN ACADEMY OF ACTUARIES AND A CHARTERED PROPERTY AND CASUALTY UNDERWRITER. PRIOR TO MY EMPLOYMENT AT BENFIELD I WAS CHIEF ACTUARY AND UNDERWRITER OF USAA.

LET ME OFFER A FEW WORDS OF EXPLANATION OF MY FIRM BEFORE I BEGIN MY MORE FORMAL REMARKS. BENFIELD IS THE LARGEST INDEPENDENT GLOBAL REINSURANCE INTERMEDIARY. OUR CURRENT FORM CAME INTO BEING IN 2001 THROUGH FROM THE MERGER OF BENFIELD, GRIEG OF THE U.K. AND E.W. BLANCH OF THE U.S.

BENFIELD AND ITS PREDECESSOR ORGANIZATIONS HAVE HAD EXTENSIVE EXPERIENCE IN THE FLORIDA HURRICANE INSURANCE

MARKET. WE WERE THE FIRST TO DEVELOP HURRICANE MODELS. ALSO, THROUGH OUR PARAGON SUBSIDIARY, WE HAVE BEEN SELECTED TO ADMINISTER THE FLORIDA HURRICANE CATASTROPHE FUND (FHCF) SINCE THE FUND'S INCEPTION. OUR EXPERIENCE IN THE AREA OF CATASTROPHE MANAGEMENT HAS BEEN FURTHER RECOGNIZED BY BEING SELECTED TO BE THE ADMINISTRATOR OF THE FEDERAL TERRORISM COVERAGE THROUGH THE T.R.I.A. LEGISLATION AS WELL RECENTLY BEING SELECTED AS THE REINSURANCE BROKER FOR CITIZENS.

BENFIELD AND ITS PREDECESSOR, E.W. BLANCH, HAS PLACED REINSURANCE ON BEHALF OF ITS CLIENTS EXPOSED TO FLORIDA HURRICANE CATASTROPHES FOR OVER 50 YEARS. FOR THE CURRENT HURRICANE SEASON WE HAVE PLACED A SUBSTANTIAL SHARE OF THE DOLLARS OF REINSURANCE CAPACITY AT RISK IN FLORIDA INTO THE GLOBAL REINSURANCE MARKETS. THIS PUTS US SQUARELY IN THE CENTER OF PROVIDING PROPERTY INSURANCE PROTECTION FOR FIRMS OPERATING IN THIS STATE.

WE ARE HONORED TO BE ASKED TO OFFER AN INDUSTRY PERSPECTIVE AT THIS FIRST MEETING OF THE TASK FORCE FOR LONG TERM SOLUTIONS. HOWEVER, WE DO NOT PURPORT TO SPEAK FOR THE ENTIRE INSURANCE INDUSTRY. THE POSITIONS WE OFFER MAY BE

CONSTRUED TO HAVE AN INDUSTRY PERSPECTIVE, BUT THE INDUSTRY IS MADE UP OF DOZENS OF INDIVIDUAL FIRMS WHO DO NOT NECESSARILY SPEAK WITH A SINGLE VOICE. OUR POSITIONS ARE OURS ALONE AND COME FROM OUR OWN PERSPECTIVE AS A REINSURANCE INTERMEDIARY WHO REMAINS CLOSELY IN TOUCH WITH THE CLIENTS THAT WE REPRESENT, ALL OF WHOM HAVE AN INTEREST IN THE LONG TERM VIABILITY OF THE FLORIDA INSURANCE MARKETPLACE.

YOUR CHARGE FROM THE LEGISLATION PASSED EARLIER THIS YEAR IS A CHALLENGING ONE. SPECIFICALLY YOU HAVE BEEN ASKED TO MAKE RECOMMENDATIONS TO THE LEGISLATIVE AND EXECUTIVE BRANCHES RELATING TO THE CREATION AND MAINTENANCE OF INSURANCE CAPACITY IN THE PUBLIC AND PRIVATE SECTOR SUFFICIENT TO ASSURE APPROPRIATE INSURANCE FOR HURRICANE LOSSES.

YOU ARE TO EXAMINE THE COMPLEX PUBLIC AND PRIVATE FINANCIAL STRUCTURE THAT HAS EVOLVED THROUGH LEGISLATION, REGULATION AND ACTIONS OF PRIVATE FIRMS OVER MANY YEARS. IN ADDITION, OVER THESE YEARS THE STATE HAS ENJOYED AN UNPRECEDENTED POPULATION EXPANSION AND BUILDING BOOM.

IT COULD BE ARGUED THAT THIS EXPANSION COULD ONLY HAVE BEEN BROUGHT ABOUT THROUGH THE EXISTENCE OF THE HEDGING

MECHANISMS THAT HAVE BEEN IN PLACE. RECENT EVENTS HAVE LED TO A NEED TO RE-EXAMINE WHETHER THERE IS SUFFICIENT CAPACITY TO SUSTAIN CONTINUED DEVELOPMENT LET ALONE AFFORDABLY COVER THE NEEDS OF THE CURRENT POPULATION.

THE FINANCIAL STRUCTURES THAT EXIST TODAY HAVE NOT BEEN PUT IN PLACE OVERNIGHT AND SO WE SHOULD NOT EXPECT OVERNIGHT SOLUTIONS. THE LEGISLATURE UNDERSTOOD THIS AND ASKED FOR YOU TO LOOK AT ALL ASPECTS TO RECOGNIZE WHAT LOOKS RIGHT AND WHAT NEEDS TO CHANGE. THE QUESTIONS YOU HAVE BEEN ASKED TO EXAMINE ARE COMPLEX AND DIFFICULT. THERE IS NO ONE SILVER BULLET THAT WILL MAKE THIS EXPOSURE GO AWAY.

TO ACHIEVE THE BENEFITS OF HAVING A TASK FORCE LIKE THIS TO TAKE A LONG TERM VIEW IT MUST BEGIN FROM SOME FUNDAMENTAL AGREEMENT ON THE STEPS NECESSARY TO ACHIEVE ADEQUATE CAPITAL. ANY SOLUTIONS SHOULD BE FRAMED WITHIN AN OVERALL SET OF PRINCIPLES OR GOALS CONSISTENT WITH THAT OBJECTIVE.

WHAT WE WOULD LIKE TO DO IN OUR STATEMENT IS TO ATTEMPT TO RAISE SOME STRATEGIC ELEMENTS OF A LONG RANGE SOLUTION. TO GIVE YOU A PREVIEW OUR STRATEGIC ELEMENTS ARE THE FOLLOWING:

1. RECOGNIZE THE TRUE COSTS OF COVERAGE BY ELIMINATING PRICE CONTROLS.
2. FOCUS REGULATOR EFFORT ON SOLVENCY BY REALISTICALLY APPRAISING NEW CAPITAL.
3. END UNFAIR SUBSIDIZATION.
4. REALIZE THE WEAKNESSES OF ACCOUNTING FOR FINANCIALLY CATASTROPHIC EVENTS.
5. CONTINUE TO MAKE THE MOST OF YOUR TAX STATUS
6. NURTURE A SPIRIT OF COOPERATION AND TRUST AMONG THE STAKEHOLDERS

I WILL ELABORATE ON EACH OF THESE LATER IN MY STATEMENT.

SPECIFIC TACTICS AND ANALYSIS OF CURRENT AND FUTURE MECHANISMS COULD FOLLOW. WE WOULD BE HAPPY TO PARTICIPATE IN ANY DELIBERATIONS ON THESE.

IN THE REMAINDER OF OUR STATEMENT WE WILL BRIEFLY PROVIDE A METEOROLOGICAL PERSPECTIVE, FOLLOWED BY AN OVERVIEW OF WHERE WE ARE TODAY, EXAMINE A BIT OF GOOD NEWS THAT HAS EMERGED AND DISCUSS IN MORE DEPTH THE STRATEGIC PRINCIPLES

THAT WE OUTLINED.

METEOROLOGICAL PERSPECTIVE

FLORIDA HAS BEEN EXPOSED TO SEASONALLY DEVASTATING HURRICANES FOR CENTURIES. ITS POSITION AS A PENINSULA IN THE ATLANTIC JUTS OUT INTO HARMS WAY FOR ANY NUMBER OF SEVERE LAND FALLING TROPICAL CYCLONES THAT FORM OFF THE COAST OF WEST AFRICA IN THE SUMMER AND EARLY FALL SPAWNED BY THE WARM ATLANTIC WATERS.

MUCH SCIENCE HAS BEEN DEVOTED TO PREDICTING THE ANNUAL FREQUENCY AND SEVERITY OF HURRICANES. CURRENT RESEARCH INTO WHETHER THIS IS INFLUENCED BY GLOBAL WARMING HAS BEEN VERY CONTROVERSIAL AND INCONCLUSIVE TO THIS POINT. NEVERTHELESS, THE RECORD SINCE 1850 AS POINTED OUT BY THE OIR HAS HAD SOME CYCLICALITY. THEY POINTED OUT THAT, "WHILE ONLY 4 MAJOR HURRICANES (CATEGORY 3 AND HIGHER) MADE LANDFALL IN FLORIDA FROM 1980 TO 1990, 18 MAJOR HURRICANES LANDED IN FLORIDA BETWEEN 1910 AND THE MID 1950'S. THAT WAS FOLLOWED BY A FAIRLY QUIET HURRICANE PERIOD UNTIL THE MID 1990'S." ¹ BECAUSE OF THE FAST PACED REAL ESTATE DEVELOPMENT AND POPULATION

¹ Florida Office of Insurance Regulation, The Property Insurance Market in Florida 2004: The Difference a Decade Makes, March 2005.

SURGE, HURRICANES IN FLORIDA THAT IN THE PAST ONLY IMPACTED ALLIGATORS AND ORANGE GROVES ARE NOW IMPACTING PEOPLE AND PROPERTY.

IN MANY YEARS THERE HAVE BEEN NO LAND FALLING HURRICANES. IN 2004 THERE WERE FOUR STRONG LAND FALLING HURRICANES DAMAGING FLORIDA, WITH SOME AREAS INLAND RECEIVING THE IMPACTS OF THREE STORMS. IN THESE EVENTS CLAIMS PAYMENTS EXCEEDED \$20 BILLION. MANY WONDER WHETHER THIS IS A TREND OR AN ABERRATION.

ONLY TIME WILL TELL WHETHER CONCLUSIVE RESULTS CAN BE ACHIEVED IN THE AREA OF PREDICTION. AS A MATTER OF FINANCIAL REALITY AND TO DEVELOP SOUND PUBLIC POLICY, ONE MUST ASSUME THAT THE STATE WILL CONTINUE TO BE IMPACTED BY DEVASTATING EVENTS WITH SOME FREQUENCY. CERTAINLY PUBLIC SAFETY AND EVACUATION PLANNING HAS BEEN VERY SUCCESSFUL IN BASING THEIR PREPARATION ON THAT ASSUMPTION, BUT FINANCIAL PLANNING SEEMS TO HAVE LAGGED BEHIND.

HOW WE GOT TO WHERE WE ARE TODAY

ROBERT HARTWIG, CHIEF ECONOMIST OF THE INSURANCE INFORMATION INSTITUTE HAS TESTIFIED TO THE LEGISLATURE AND TO OTHER GROUPS IN GREAT DETAIL AS TO THE IMPACT OF HURRICANE EXPOSURE TO THE ECONOMY IN FLORIDA.² HIS MANY CHARTS AND IN DEPTH DESCRIPTIONS ARE WORTHY OF THE TASK FORCE'S FULL EXAMINATION. I WILL TAKE THE LIBERTY TO PARAPHRASE SOME OF HIS OBSERVATIONS.

- THE ONLY LONG-TERM MEASURE OF SUCCESS OF ANY BUSINESS, INCLUDING INSURANCE, IS SUSTAINED PROFITABILITY. IN REALITY, FLORIDA'S HOMEOWNERS INSURANCE MARKET HAS NEVER BEEN PROFITABLE OR SELF-SUSTAINING.
- INVESTORS CAN NOT, WILL NOT AND SHOULD NOT TOLERATE CONSISTENT LOSSES IN AN INSURER'S MAJOR OPERATIONS. THEY HAVE A REASONABLE EXPECTATION THAT THE SITUATION WILL BE FIXED.
- CAPITAL IS FINITE AND MUST BE TREATED AS A PRECIOUS COMMODITY BY INSURERS WHO ARE ENTRUSTED BY INVESTORS WITH ITS CARE.
- RUINOUS LOSSES ARISING FROM FUTURE STORMS ARE A VIRTUAL GIVEN.

² Robert, P. Hartwig, Ph.D., CPCU, Senior Vice President and Chief Economist, Insurance Information Institute, Testimony as delivered to the Florida Joint Select Committee on Hurricane Insurance, January 19, 2005.

- IT TOOK INSURERS 11 YEARS TO FINALLY EARN BACK WHAT THEY LOST IN HURRICANE ANDREW, BUT WITHIN A SPAN OF JUST 6 WEEKS IN 2004, INSURERS ONCE AGAIN FOUND THEMSELVES DEEPLY IN THE RED.
- FLORIDA IS A FAST GROWING STATE. IN ORDER TO SUPPORT THIS GROWTH, FLORIDA WILL NEED TO ATTRACT LARGE AMOUNTS OF CAPITAL IN THE YEARS AHEAD.
- ANY TRUE SOLUTION SHOULD SEEK TO PROVIDE CAPITAL WITH A REASONABLE RATE OF RETURN. APPROPRIATE RATES ARE ONLY ONE PART OF THE SOLUTION. CONTINUED EFFORTS TO STRENGTHEN BUILDING CODES, ADOPT WISE LAND USE POLICIES AND ENCOURAGE MITIGATION MUST ALL PLAY A ROLE.

SOME GOOD NEWS

THERE ARE TWO IMPORTANT AREAS TO RECOGNIZE WHERE PROGRESS HAS BEEN MADE OVER THE YEARS SINCE HURRICANE ANDREW: EFFECTIVE BUILDING CODES AND MATURITY OF CATASTROPHE MODELING.

- EFFECTIVE BUILDING CODES

AS THE OIR REPORTED IN ITS MARCH 2005 REPORT³ “CHANGES IN BUILDING CODES IN DEFINED HIGH RISK AREAS ARE HELPING TO

³ Florida O.I.R., op.cit.

ENSURE THAT NEWLY CONSTRUCTED PROPERTIES ARE MORE RESISTANT TO HURRICANE DAMAGE THAN WAS TRUE IN THE PAST.”

WE ARE BEGINNING TO SEE THESE RESULTS IN ENGINEERING STUDIES THAT HAVE RECENTLY BEEN COMPLETED OR ARE NEARING COMPLETION. FOR EXAMPLE, PRELIMINARY RESULTS OF A POST 2004 HURRICANE FIELD STUDY UNDERTAKEN BY THE UNIVERSITY OF FLORIDA GAINESVILLE, FLORIDA INTERNATIONAL UNIVERSITY AND THE INSTITUTE FOR BUSINESS AND HOME SAFETY ARE SHOWING ENCOURAGING RESULTS ON THE EFFECTIVENESS OF BUILDING CODE CHANGES. THEIR FINDINGS DEMONSTRATE THE EFFECTIVENESS OF WINDOW PROTECTION, IMPROVEMENT IN SHINGLE PERFORMANCE, AND BETTER ROOF PERFORMANCE FROM NEWER ROOFS. IT WAS CLEAR TO THE TEAMS CONDUCTING GROUND BASED SURVEYS IMMEDIATELY AFTER THE STORMS THAT NEWER BUILDINGS, PRESUMABLY BUILT TO THE LATEST BUILDING CODES AND STANDARDS PERFORMED BETTER THAN OLDER BUILDINGS. ⁴

- MATURITY OF CATASTROPHE MODELING

CATASTROPHE MODELS FORM THE ONLY OBJECTIVE BASIS FROM WHICH TO ASSESS HURRICANE LOSS POTENTIAL. THESE MODELS ARE USED IN SETTING OVERALL RATE LEVELS, EVALUATING DIFFERENCES

⁴ US Hurricanes of 2004: A Clear Demonstration That Improvements in Building Codes/Enforcement and Construction are Reducing Structural Damage, IBHS Disaster Safety Review, Summer 2005.

IN LOSS PROPENSITY BY GEOGRAPHIC AREA AS WELL AS HELPING TO EVALUATE THE LEVEL OF CAPITAL THAT A FIRM SHOULD RETAIN.

THE FLORIDA COMMISSION ON HURRICANE LOSS PROJECTION METHODOLOGY WAS CREATED DURING THE 1995 LEGISLATIVE SESSION AS AN INDEPENDENT PANEL OF EXPERTS TO EVALUATE COMPUTER MODELS AND OTHER RECENTLY DEVELOPED OR IMPROVED ACTUARIAL METHODOLOGIES FOR PROJECTING HURRICANE LOSSES.

THE LEGISLATURE SPECIFICALLY DETERMINED THAT RELIABLE PROJECTIONS OF HURRICANE LOSSES ARE NECESSARY TO ASSURE THAT RATES FOR RESIDENTIAL PROPERTY INSURANCE ARE NEITHER EXCESSIVE NOR INADEQUATE, AND THAT COMPUTER MODELING HAS MADE IT POSSIBLE TO IMPROVE UPON THE ACCURACY OF HURRICANE LOSS PROJECTIONS.

THE COMMISSION HAS ACCEPTED SEVERAL MODELS FOLLOWING RIGOROUS AND OBJECTIVE DUE DILIGENCE. THE EXISTENCE OF THE COMMISSION FORCED MODELING FIRMS TO LOOK AT THE ASSUMPTIONS THEY WERE MAKING AND OPEN THEM UP TO SCRUTINY BY THE PUBLIC. WHILE THERE ARE STILL PROPRIETARY DIFFERENCES AMONG THE MODELING FIRMS, IT IS CLEAR THAT THE EFFORTS TO MAKE THESE MODELS MORE TRANSPARENT HAS INCREASED THE

DEGREE OF TRUST THAT POLICYMAKERS HAVE WITH WHAT HERETOFORE HAD BEEN CONSIDERED A “BLACK BOX.”

THE MODELS ARE BY NO MEANS PERFECT. THEY ARE CONTINUALLY BEING UPDATED TO REFLECT THE LATEST SCIENCE. ACTUAL HURRICANE EVENTS PROVIDE FURTHER GUIDANCE FOR REFINING THESE MODELS OVER TIME.

STRATEGIC PRINCIPLES TO EVALUATE SOLUTIONS

WE ARE SURE THAT THE TASK FORCE CAN COME UP WITH ADDITIONAL ELEMENTS TO CONSIDER BUT WHAT WE HAVE FOR YOU TO THINK ABOUT ARE SOME OPERATING PRINCIPLES AND GOALS THAT YOU MAY WANT TO REFLECT ON AS YOU DELIBERATE FURTHER.

1. RECOGNIZE THE TRUE COSTS OF COVERAGE BY ELIMINATING PRICE CONTROLS

INSURANCE FOR HURRICANES SIMPLY DOES NOT HAVE THE BENEFIT OF PREDICTIVENESS THAT PERSONAL AUTO INSURANCE HAS. IN AUTO, THOUSANDS OF CLAIMS OCCUR EACH DAY AND THE LAW OF LARGE NUMBERS CAN BE APPLIED WITH STATISTICAL PRECISION. NEVERTHELESS CATASTROPHE MODELING AS DISCUSSED EARLIER HAS EMERGED AS THE NECESSARY TOOL FOR RISK ASSESSMENT.

ACCEPTED MODELS SHOULD BE APPLIED WITHOUT ANY ARTIFICIAL CURTAILMENT OR RIGID PRICE CONTROLS. RATES SHOULD BE ALLOWED TO STRICTLY FOLLOW ACTUARIAL RATEMAKING PRINCIPLES (SEE ATTACHMENT 1). THIS INCLUDES BEING ALLOWED TO INCLUDE THE FULL COST OF CAPITAL.

WE URGE THE TASK FORCE TO EXAMINE THE RATIONALE FOR CONTINUING TO REVIEW AND APPROVE PRICES. INSURANCE IS CLEARLY A COMPETITIVE MARKET AND WITH DOZENS OF PROVIDERS. IT IS HARDLY A UTILITY. THE RATE APPROVAL PROCESS CAN BE CONTRARY TO THE GOAL OF ACQUIRING ADEQUATE CAPITAL TO FUND FLORIDA'S HURRICANE EXPOSURE BECAUSE BY DEFINITION IT FORCES RATES TO A LEVEL THAT IS NOT MARKET BASED.

NO OTHER PUBLICLY NECESSARY COMPETITIVE BUSINESS HAS TO SUBMIT TO THE SCRUTINY OF STATE FILING REQUIREMENTS AS INSURANCE DOES. OUR FREE MARKET ECONOMY ALLOWS PRICES FOR ALL KINDS OF ESSENTIAL GOODS TO FLOAT TO THE LEVEL THAT ACHIEVES SUPPLY FOR THE DEMAND. YOU NEED ONLY LOOK AT TODAY'S GASOLINE PRICES TO SEE AN EVEN MORE URGENT CALLING ON CONSUMERS' POCKETBOOKS. YET NO ONE SEEMS TO BE ADVOCATING PRIOR APPROVAL OF GASOLINE PRICES.

FUNDING NEED NOT TAKE THE FORM OF RATE INCREASES ALONE. WHILE WIND DEDUCTIBLES HAVE BEEN INCREASING OVER THE PAST FEW YEARS, THERE IS STILL CONSIDERABLE SAVINGS TO BE ACHIEVED BY ENCOURAGING STILL HIGHER DEDUCTIBLES. WITH THE GREATEST NUMBER OF LOSSES NOT TOTALS, THIS COULD HAVE A LARGE IMPACT ON THE AMOUNT OF CAPITAL REQUIRED. AS AN EXAMPLE, IN CALIFORNIA THE STANDARD EARTHQUAKE DEDUCTIBLE IN THE SO-CALLED MINI-POLICY IMPLEMENTED BY THE LEGISLATURE FOLLOWING THE NORTHRIDGE EARTHQUAKE IN 1994 HAS BEEN 15% OF THE HOME VALUE. RESIDENTS THERE CAN BUY THIS DEDUCTIBLE DOWN TO 10% FOR AN ADDITIONAL CHARGE. IN ADDITION, THE MINI-POLICY RESTRICTS CONTENTS COVERAGE AND ADDITIONAL LIVING EXPENSES. WHILE THIS MAY SEEM DRACONIAN IN FLORIDA RELATIVE TO WHERE YOU ARE TODAY, IT NEEDS TO BE ADDED INTO THE MIX OF POSSIBLE SOLUTIONS. IF AN EVENT OCCURS A DEDUCTION FROM INCOME TAXES FOR DISASTER LOSSES IS AVAILABLE.

2. FOCUS REGULATOR EFFORT ON SOLVENCY BY REALISTICALLY APPRAISING NEW CAPITAL

WITH THE INCREASE IN MARKET SHARE OF CITIZENS, THE LOGICAL QUESTION THAT HAS BEEN ASKED IS HOW WE CAN ENCOURAGE RISKS TO BE MOVED TO PRIVATE MARKETS? IN THE PRESENT ENVIRONMENT

WE SEE SEVERAL CARRIERS RESTRICTING NEW BUSINESS, WHILE NEW START UPS ARE WILLING TO TAKE BUSINESS OUT OF CITIZENS.

THE STATE HAS EMBARKED ON A BONUS PROGRAM TO INCENT PRIVATE MARKETS TO TAKE ON WHAT HAD PREVIOUSLY BEEN RISKS THAT WERE UNABLE TO BE WRITTEN IN PRIVATE MARKETS. THE BONUS ADDED TO THE ALLOWED PREMIUM SEEMS TO HAVE PROVIDED IN MANY CASES JUST THE RIGHT AMOUNT OF SWEETENER TO GET THESE RISKS OUT OF CITIZENS AND INTO PRIVATE MARKETS.

ALL THIS IS WELL AND GOOD IN THE SHORT RUN AND PERHAPS THE LONG RUN. THE KEY QUESTION TO BE ASKED HERE IS WHETHER THE STATE HAS FULLY EXPLORED THE FINANCIAL CREDITWORTHINESS OF EACH NEW ENTITY. TO WHAT EXTENT ARE THESE FIRMS STRESS TESTED? IS THIS NEW CAPITAL NAÏVE AND SUBJECT TO INSOLVENCY AT THE NEXT MODERATE TO STRONG HURRICANE EVENT? OR PERHAPS IS THIS NEW CAPITAL PRECISELY DETERMINED TO BE JUST ENOUGH TO CLEAR INITIAL REGULATORY SCRUTINY, BUT ACTUALLY DESIGNED TO BE UNABLE TO RESPOND TO THE NEXT MAJOR EVENT?

IT DOES LITTLE GOOD TO HAVE APPROVED AN UNDERCAPITALIZED ENTITY SO AS TO TAKE BUSINESS OUT OF CITIZENS, SIMPLY FOR IT TO

WIND UP PAYING CLAIMS OUT OF THE GUARANTY FUND WHEN THE NEW ENTITY GOES UNDER.

3. END UNFAIR SUBSIDIZATION

AS DISCUSSED EARLIER, TODAY'S CATASTROPHE MODELS ARE THE TOOLS THAT MOST ACCURATELY ASSESS EXPOSURE DIFFERENCES BY GEOGRAPHIC AREA. THEY ALSO TAKE INTO CONSIDERATION A VARIETY OF FACTORS SUCH AS ELEVATION AND OTHER TERRAIN FEATURES. THIS ENABLES RISKS TO BE WEIGHED RELATIVE TO EACH OTHER.

INTUITIVELY ONE WOULD IMAGINE THAT A RISK RIGHT ON THE COAST WOULD HAVE MORE VULNERABILITY TO DAMAGE IN AN EVENT THAN ONE THAT IS, SAY, TWO MILES INLAND. BUT THERE IS NO NEED TO RELY ON INTUITION WHEN A REALISTIC APPRAISAL CAN BE MADE. RATES CAN NOW BE ACCURATELY BASED ON RELATIVE RISK.

CITIZENS, AS THE INSURER OF LAST RESORT, HAS BY ITS NATURE INSTITUTIONALIZED A FORM OF UNFAIR SUBSIDIZATION. THIS IS BECAUSE MANY OF THE HIGHER END PROPERTY RISKS IT TAKES ON COULD POSSIBLY HAVE BEEN WRITTEN IN THE PRIVATE MARKET AT THE RIGHT PRICE FOR THE EXPOSURE. ACCORDING TO THE PALM BEACH

POST, CITIZENS INSURES MOST OF THE HIGHER END PROPERTY ALONG FLORIDA'S COASTLINE.⁵

4. REALIZE THE WEAKNESSES OF ACCOUNTING FOR FINANCIALLY CATASTROPHIC EVENTS

MOST PEOPLE DO NOT THINK ABOUT CLOSING THE BOOKS ANNUALLY AS AN ACCOUNTING PARADIGM. IT JUST SEEMS NATURAL THAT AT THE END OF THE YEAR WE SHOULD BE ABLE TO DETERMINE WITH SOME ACCURACY WHETHER WE MADE OR LOST MONEY. UNFORTUNATELY THIS PARADIGM HAS NEGATIVE CONSEQUENCES FOR PUBLIC POLICY WHEN WE ARE TRYING TO ENCOURAGE CAPACITY FOR EVENTS THAT ARE DEVASTATING BUT INFREQUENT. IN ANY GIVEN YEAR THE PROVISION IN RATES FOR CATASTROPHES WILL BE A BROAD AVERAGE, YET THE ACTUAL EXPERIENCE IN THAT YEAR WILL RARELY EQUAL THAT AVERAGE. IN FACT, IN MOST YEARS IF THE CATASTROPHE PROVISION IS ACCURATE, CATASTROPHE LOSSES WILL BE LESS THAN THE AVERAGE TO ALLOW FOR YEARS LIKE 1992 AND 2004 WITH FAR ABOVE AVERAGE LOSSES.

IT IS TEMPTING TO LOOK AT THE ANNUAL EXPERIENCE IN YEARS WHEN NO MAJOR EVENTS OCCUR AND OBSERVE WHAT ONE COULD ARGUE AS TO BE EXCESS PROFITS REALIZED BY INSURERS. WE NEED TO

⁵ Insurance Crisis for Florida Homeowners, Palm Beach Post, December 11, 2004.

UNDERSTAND THAT IN THESE YEARS WE ARE, IN ESSENCE, SAVING UP IN RETAINED EARNINGS FOR THE INEVITABLE YEAR WHICH WILL INCUR MUCH MORE THAN THE ANNUAL AVERAGE PROVISION.

AS A DIRECT RESULT OF THIS ACCOUNTING PARADIGM, INSURERS ARE TAXED ON WHAT APPEAR TO BE PROFITS. IN REALITY THESE PROFITS ARE UNREALIZED PROVISIONS FOR CATASTROPHE LOSSES. THIS INHIBITS INSURERS' ABILITY TO SAVE UP FOR THE NEXT BIG EVENT AS A CONSIDERABLE AMOUNT OF THE CATASTROPHE PROVISION IS SKIMMED OFF IN TAXES FROM NOMINAL PROFITS.

5. CONTINUE TO MAKE THE MOST OF YOUR TAX STATUS

IN STRUCTURING THE FHCF THE LEGISLATURE CONSIDERED THE ACCOUNTING PHENOMENON JUST DESCRIBED AND WAS ABLE TO ACHIEVE A TAX EXEMPTION WHICH PERMITS THEM TO ACCUMULATE CAPITAL UNENCUMBERED BY A DRAIN ON FUNDS FROM TAXES. THIS EXEMPTION IS NOT AVAILABLE TO PRIVATE ENTITIES. ACCORDING TO THE CLAIM PAYING CAPACITY CHART ON THE FHCF WEBSITE, THIS HAS ALLOWED THE FHCF TO GROW TO A CASH BALANCE OF \$6.1 BILLION IN 2004. HOWEVER, FOLLOWING PAYMENTS FROM CLAIMS FOR 2004 EVENTS THE CURRENT CASH BALANCE IS APPROXIMATELY \$2.9

BILLION. WITH BONDING CAPACITY THROUGH ASSESSMENTS THE FHCF CAN NOW COVER \$15 BILLION IN INITIAL SEASON CLAIMS PAYING CAPACITY AND \$15 BILLION IN SUBSEQUENT SEASON CLAIMS PAYING CAPACITY.

TO MAXIMIZE CAPITAL OVERALL, FLORIDA SHOULD CONTINUE TO EXPLOIT THIS TAX ADVANTAGE. WHILE SOME WITHIN THE INSURANCE INDUSTRY MAY ARGUE THAT THIS “CROWDS OUT” PRIVATE CAPITAL, THE PRIVATE CAPITAL SIMPLY CANNOT COMPETE WITH THE ADVANTAGE THAT THE FHCF HAS IN ITS ABILITY TO ACCUMULATE CAPITAL. IT WOULD BE A MISTAKE NOT TO UTILIZE THIS TO MAXIMIZE THE BENEFITS TO FLORIDA CONSUMERS.

6. NURTURE A SPIRIT OF COOPERATION AND TRUST AMONG STAKEHOLDERS

THIS TASK FORCE HAS A UNIQUE OPPORTUNITY AT THIS TIME TO BRING TOGETHER THE VIEWS OF ALL STAKEHOLDERS. IT WOULD NOT BE AN UNDERSTATEMENT TO OBSERVE THAT THE FUTURE VIABILITY OF THE FLORIDA ECONOMY WILL DEPEND ON THE EFFECTIVENESS OF WHATEVER PROPOSALS YOU FINALLY RECOMMEND. SOLUTIONS WILL EVOLVE OVER TIME AND YOUR RECOMMENDATIONS WILL

UNDOUBTEDLY NEED TO BE REVIEWED OVER THE ENSUING YEARS TO MAKE SURE THEY ARE STILL RELEVANT. TOWARD THAT END, ONE ENDURING CONTRIBUTION THAT YOU COULD MAKE WILL BE TO LOWER THE RHETORIC AND COME TOGETHER IN A CONCILIATORY MANNER.

WE ARE ALL IN THIS TOGETHER. WE MUST RESPECT EACH OTHER'S PERSPECTIVE AS WE ALL ATTEMPT TO FACE UP TO THE CERTAINTY OF LARGE FUTURE HURRICANES. THIS IS NO TIME FOR GRANDSTANDING OR THE BLAME GAME. IT IS A TIME TO CAREFULLY LISTEN TO THE RANGE OF OPTIONS, MANY OF WHICH ARE LIKELY TO REQUIRE SOME FORM OF SACRIFICE. THE EXPOSURE FACED IN FLORIDA IS NOBODY'S FAULT, IT IS REAL AND IT IS NOT GOING AWAY.

CONCLUSIONS

STEPPING BACK FOR A MOMENT, WHEN YOU CUT THROUGH ALL THE CLUTTER OF THE DATA AND THE DIALOG, THE EXPOSURE IN FLORIDA IS VAST. ULTIMATELY THE PROVIDERS OF PRIVATE CONTINGENT CAPITAL SUPPORT INFREQUENT CATASTROPHIC SURGES OF CASH FLOW. THEY WILL NEED TO BE CONVINCED THAT PUTTING THEIR CAPITAL AT RISK PROVIDES THEM WITH A REASONABLE RATE OF RETURN RECOGNIZING FLORIDA'S INHERENT VOLATILITY AND RISK. TAX POLICY CAN PROVIDE

SOME RELIEF AS DEMONSTRATED BY THE BENEFIT ACHIEVED FROM THE EXEMPTION FROM TAXES PROVIDED TO THE CAT FUND.

IN OUR ECONOMIC SYSTEM, CAPITAL WILL FLOW TO WHERE IT CAN ACHIEVE THE HIGHEST RETURNS. THIS MEANS THAT CURRENT ASSUMPTIONS OF WHAT PROPERTY INSURANCE COSTS HAS TO CHANGE. LIVING IN HARM'S WAY IS EXTREMELY RISKY. THOSE WHO LIVE HERE HAVE LONG BEEN LURED INTO A DEFICIENT FUNDING LEVEL BECAUSE THE FUNDAMENTAL RISK FACED WAS UNDERCHARGED. MOVEMENT TOWARDS A FREE MARKET WHICH EFFICIENTLY ALLOCATES EXPOSURE TO COSTS IS THE ONLY WAY THAT A TRUE LONG TERM SOLUTION WILL BE ACHIEVED. IT WILL BE IMPOSSIBLE TO COMPLETELY ELIMINATE THE HARDSHIP THIS WILL CREATE, ESPECIALLY TO THE LOWEST INCOME CITIZENS, MUCH AS WE ARE SEEING TODAY IN THE MOVEMENT OF GASOLINE PRICES. BUT ANYTHING SHORT OF A SUFFICIENT RATE OF RETURN WILL LIMIT CAPITAL, STIFLE GROWTH AND PROVIDE SHORTAGES OF INSURANCE. THIS IS AMPLY DEMONSTRATED BY THE SURGE OF POPULARITY OF A PUBLICLY FUNDED RESIDUAL MARKET SUCH AS CITIZENS.

ATTACHMENT 1

CASUALTY ACTUARIAL SOCIETY

RATEMAKING PRINCIPLES

RATEMAKING IS PROSPECTIVE; THE RATE IS DEVELOPED PRIOR TO THE TRANSFER OF RISK. RATEMAKING SHOULD PROVIDE FOR **ALL COSTS** SO INSURANCE SYSTEM IS FINANCIALLY SOUND.

- **PRINCIPLE 1:** A *RATE* IS AN ESTIMATE OF THE EXPECTED VALUE OF FUTURE COSTS.
- **PRINCIPLE 2:** A RATE PROVIDES FOR **ALL COSTS** ASSOCIATED WITH THE TRANSFER OF RISK.
- **PRINCIPLE 3:** A RATE PROVIDES FOR THE COSTS ASSOCIATED WITH AN INDIVIDUAL RISK TRANSFER.
- **PRINCIPLE 4:** A RATE IS REASONABLE AND NOT EXCESSIVE, **INADEQUATE**, OR UNFAIRLY DISCRIMINATORY IF IT IS AN ACTUARIALLY SOUND ESTIMATE OF THE EXPECTED VALUE OF ALL FUTURE COSTS ASSOCIATED WITH AN INDIVIDUAL RISK TRANSFER