

## **CFO Sink's Cat Fund Reform Proposal**

### **Problem: State (taxpayers) took on too much risk in the CAT Fund**

1. The Legislature added a \$12 billion optional layer to the Florida Hurricane Catastrophe Fund, bringing state's risk to \$28 billion, with an option to expand up to \$32 billion.
2. The state took on additional risk to provide discounts in property insurance rates... Floridians were advised to expect an average of 24 percent
3. The CAT Fund expansion did not produce the expected rate reductions, and now Floridians are on the hook for a potential \$12 billion in damages. This leaves open the possibility of assessments (taxes) on Floridians if a very bad storm hits our state.

### **Challenges: Making changes to levels and prices of reinsurance in the CAT Fund is very difficult and is limited to a 60-day spring legislative window.**

1. In order to reduce the state's risk, Florida law must be changed, which requires action by the Legislature.
2. Making changes to levels and prices of reinsurance in the CAT Fund is very complex and would not be easy for a 160-member body to do outside of the upcoming 2008 regular session.
3. If the change is not made until the 2008 regular session, the new levels and prices would not be in effect before May 2008 (one month before Hurricane Season).

### **Solution: Give the Florida Cabinet the authority to set levels and prices of reinsurance in CAT Fund.**

1. Reducing Risk-- The Cabinet will be able to analyze the issue and set the appropriate risk level each year.
2. Timing-- The Cabinet will be able to set levels and pricing during the winter, months before insurance companies make their reinsurance purchasing decisions.
3. More Nimble-- The Cabinet will be able to respond to the market-- much like the Federal Reserve-- and quickly make needed changes to reinsurance levels and prices.
4. More Accountability-- Moving CAT Fund administration under the Cabinet will increase accountability of its management, with four statewide elected leaders managing the Fund as opposed to 160 lawmakers.

**Chief Financial Officer Alex Sink  
Florida Hurricane Catastrophe Fund  
Policy Proposal**

**October 9, 2007**

**Executive Summary**

- 1. Reorganization of the FHCF: Creates the Division of the FHCF to report directly to a “Board” made up of the Governor and the Cabinet.**
- 2. The Division of the FHCF evaluates the reinsurance markets and the feasibility/risk associated with bond transactions relative to current financial markets. Provides for a public records and meetings exemptions (in a separate bill).**
- 3. The Division of the FHCF shall make recommendations to the “Board” regarding which FHCF optional coverages to offer, limits, and pricing for such FHCF optional coverages for the upcoming reimbursement contract year based on its evaluation of the financial markets and the private reinsurance markets.**
- 4. The “Board” shall be authorized by the Legislature to determine the FHCF optional coverages to offer, the limits, and the pricing for such FHCF optional coverages by February 15 prior to the reimbursement contract year. The FHCF’s mandatory coverage would not be impacted.**
- 5. Residential property insurers would have the option to purchase their reinsurance coverage from the FHCF unless they can obtain reinsurance coverage for less in the private reinsurance market or capital markets.**
- 6. The objectives for the “Board” would be the following:**
  - a. To specify FHCF optional coverages early (by February 15 of each year) such that residential property insurers will understand their FHCF coverage prior to beginning negotiations with private reinsurers**
  - b. To determine the “best” FHCF optional coverage based on balancing the cost to residential policyholders and the limits of the FHCF’s financial capabilities.**
  - c. To price FHCF optional coverages at levels to encourage private market participation.**
  - d. To price FHCF optional coverages at levels to ensure that residential policyholder’s premiums are not excessive.**
  - e. To provide a mechanism to promote stability in the residential property insurance market.**
  - f. To create the Division of the FHCF to report to a “Board” designed as the Governor and the Cabinet.**

## Summary

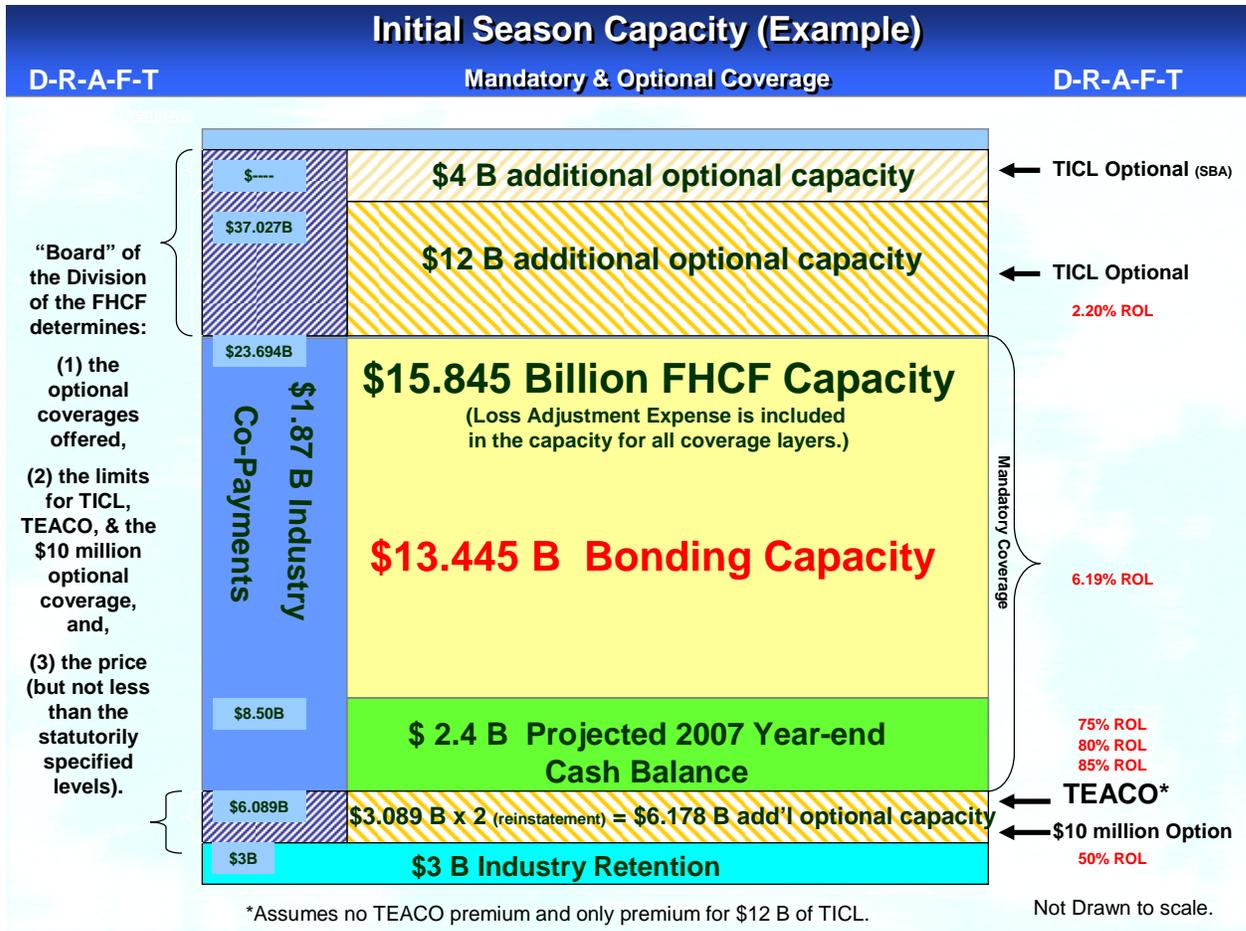
- 1. Reorganization of the FHCF: Creates the Division of the FHCF to report directly to a “Board” consisting of the Governor and the Cabinet**
  - a. Create a Division within the SBA similar to the Division of Bond Finance.
  - b. Reorganize the Florida Hurricane Catastrophe Fund (FHCF) so that it is administered by the Division of the Florida Hurricane Catastrophe Fund.
  - c. The Director of the Division of the FHCF would be the chief administrator and report to the “Board” of the Division.
  - d. The Director would be appointed by the Board.
  
- 2. The Division of the FHCF evaluates the reinsurance markets and the feasibility/risk associated with bond transactions relative to current financial markets.**
  - a. The Division of the FHCF will evaluate both the financial markets and the reinsurance markets for the purpose of making recommendations to the “Board” regarding the “structure” of the FHCF’s optional coverages for the upcoming contract year which begins on June 1.
  - b. The Division of the FHCF may contract with financial consultants or insurance consultants.
  - c. A public records exemption would be created to allow the Division of the FHCF to receive documents from insurers, reinsurers, reinsurance brokers, agents, insurance industry associations, rating agencies, financial advisors, bond counsel, and bond underwriters regarding sensitive reinsurance pricing information and future bond transaction pricing.
  - d. A public meetings exemption would be created to allow the Division of the FHCF to meet with insurers, reinsurers, reinsurance brokers, agents, insurance industry associations, rating agencies, financial advisors, bond counsel, and bond underwriters to discuss sensitive private reinsurance pricing information and the implications of the FHCF optional coverage on bonding transactions.
  - e. The Division of the FHCF may request such documents or hold such meetings as are necessary to determine 1) which optional coverages are needed by insurers, 2) the limits for optional coverages offered, and 3) the pricing for the FHCF’s optional coverages based on the limits offered.
  - f. The Division of the FHCF shall evaluate the risk associated with bonding or other financings as the impact on the size of potential policyholder assessments associated with the FHCF offering optional coverages.
  
- 3. The Division of the FHCF shall make a recommendation to the “Board” regarding which FHCF optional coverages to offer, limits, and pricing for such coverages for the upcoming reimbursement contract year based on its evaluation of the financial markets and the private reinsurance markets.**
  
- 4. The “Board” would be authorized by the Legislature to determine which FHCF optional coverages to offer, their limits, and their pricing by February 15 of each year. The FHCF’s mandatory coverage would not be impacted.**

- a. The “Board” shall have the authority to specify the following:
  - i. The optional coverages offered by the FHCF
    1. The TICL Coverage
    2. The TEACO Coverage
    3. The Up to \$10 million option available to certain limited apportionment companies
  - ii. The amounts of such optional coverage up to statutory maximums
    1. For example, the TICL coverage could be offered for only \$10 billion rather than \$12 billion, etc.
    2. For example, the TEACO coverage could be provided for only \$2 billion below the FHCF’s retention rather than \$3 billion below, etc.
    3. For example, the \$10 million coverage could be reduced to only \$5 million of coverage. And/or the retention changed from 30% of a company’s policyholder’s surplus to 40% or 50%, etc.
  - iii. The price of the FHCF optional coverage offered would be determined by the “Board,” but the price for such optional coverages could not be below the prices as currently specified in the law.
    1. Examples of pricing options.
      - a. TICL could not be offered below the actuarially indicated level. However, the price for TICL could be set at a higher level. For example, three times, five times, or ten times the actuarial level. This could increase the TICL coverage pricing for the \$12 billion coverage from 2.2% ROL to 6.6% ROL (3X) or 11% ROL (5X) or 22% ROL (10X).
      - b. TEACO could not be offered below the 85% rate-on-line for the \$3 billion retention option, below 80% for the \$4 billion retention option, or below 75% for the \$5 billion retention option. However, these prices could go up. For example, 90%, 85%, and 80% respectively.
      - c. The \$10 million coverage option could not be priced below 50% (which includes one reinstatement). However, the price could be increased. For example, 60% or 70% rate-on-line.
- b. The “Board” shall determine the FHCF structure with regard to the FHCF optional coverages, the limits for such optional coverages, and the price for such coverages by February 15 of each year.
- c. In situations where the financial or reinsurance markets change due to unforeseen circumstances, the “Board” may modify its coverage specifications prior to April 1.

**5. Residential property insurers would have an incentive to purchase their reinsurance coverage from the FHCF unless they can obtain reinsurance coverage for less in the private reinsurance market or capital markets. Any additional cost for private reinsurance that duplicates the FHCF optional coverage may not be factored in a rate filing (current law).**

**6. The objectives for the “Board” would be the following:**

- a. To provide certainty as to FHCF coverage by specifying the FHCF optional coverages months in advance (by February 15) prior to most residential insurers’ renewals of their private reinsurance contracts. The idea is to avoid the necessity of making last minute legislative changes to the FHCF just prior to the start of the hurricane season when insurers are negotiating their private reinsurance coverages.
- b. To determine each year the “best” or “optimal” FHCF coverage options to offer, the limits of such coverage, and the price in order to balance the amount of FHCF coverage offered each year with the financial capabilities of the FHCF. This objective attempts to recognize the uncertainty and volatility of the financial markets and reinsurance markets.
- c. To price FHCF optional coverages at a level that will encourage private market participation. A transfer of risk to the private market would lower the FHCF’s potential debt needs and potential policyholder assessments. With the FHCF optional coverages priced closer to realistic market levels, the private reinsurance market is expected to write more Florida risks thus spreading losses on a broader basis with more hurricane losses subject to being paid from the insurance industry’s accumulated capital. Less debt will be incurred by the FHCF as a consequence and less assessments to Florida policyholders.
- d. To price FHCF optional coverages low enough to ensure that residential policyholders are not charged excessive premiums when the cost of reinsurance is factored in as an insurer expense.
- e. To provide a mechanism to promote stability in the residential property insurance market. The cost of private reinsurance can be highly volatile especially following large hurricane losses. FHCF pricing for optional coverages can help stabilize the market such that when private reinsurance prices “spike,” insurers have a viable option to avoid being entirely dependent on the private reinsurance markets.
- f. To create the Division of the FHCF within the State Board of Administration and to provide for the direct reporting of the FHCF to a “Board” designated as the Governor and the Cabinet.



**Time Table:**

- June 1** – Reimbursement Contracts signed by insurers and returned to the FHCf.
- June 30** -- If losses, second quarter loss reports due from insurers
- June 30** – The cut off date or “as of” date for exposure reporting.
- August 1** – First provisional installment reimbursement premium is due.
- September 1** – The exposure reporting date for insurers.
- September 30** -- If losses, third quarter loss reports due from insurers
- In October** – FHCf bonding capacity estimates published in the Florida Administrative Weekly.
- October 1** – Second provisional installment reimbursement premium is due.
- December 1** – Third and final “true up” installment reimbursement premium is due.
- December 31** – If losses, insurer year-end loss reports are due.
- January 15** – FHCf report/recommendations to the “Board” regarding FHCf optional coverages based on the FHCf’s financing capabilities given the financial markets and the current state/capacity of the private reinsurance market and pricing expectations for the upcoming contract year.
- February 15** – the “Board” determines what FHCf optional coverages will be offered to insurers, the limits of the optional coverages, and the price of the optional coverages.
- March 31** – If losses, first quarter loss reports due from insurers.

**April 1** – In unforeseen circumstances, the “Board” can modify its specifications of optional FHCF coverage to react to financial and reinsurance market conditions.  
**In May** – FHCF bonding capacity estimates published in the Florida Administrative Weekly.

## Florida Hurricane Catastrophe Fund TICL Layer and Assessments

The mandatory layer of FHCF coverage is \$15.845 billion and given the Florida Hurricane Catastrophe Fund's (FHCF) cash balance at year end (close to \$2 billion based on current projections), it would take an assessment of 2.49% to fund the required bonding. If we increase the coverage in \$1 billion increments for the Temporary Increase in Coverage Limits (TICL) coverage, the assessment would increase by about 0.19% per \$1 billion. The numbers below are based on an emergency assessment base of \$37.4 billion.

The illustrated numbers below are rough approximations, but should give an idea of the magnitude of different assessments associated with different TICL layers:

<u>TICL Layer</u>	<u>Capacity</u>	<u>Annual Assessment %</u>	<u>Dollars Assessed Per Year</u>
\$12 billion TICL	\$27.845 billion	4.77%	\$1,783,980,000
\$11 billion TICL	\$26.845 billion	4.58%	\$1,712,929,000
\$10 billion TICL	\$25.845 billion	4.39%	\$1,641,860,000
\$9 billion TICL	\$24.845 billion	4.20%	\$1,570,800,000
\$8 billion TICL	\$23.845 billion	4.01%	\$1,499,740,000
\$7 billion TICL	\$22.845 billion	3.82%	\$1,428,680,000
\$6 billion TICL	\$21.845 billion	3.63%	\$1,357,620,000
\$5 billion TICL	\$20.845 billion	3.44%	\$1,286,560,000
\$4 billion TICL	\$19.845 billion	3.25%	\$1,215,500,000
\$3 billion TICL	\$18.845 billion	3.06%	\$1,144,440,000
\$2 billion TICL	\$17.845 billion	2.87%	\$1,073,380,000
\$1 billion TICL	\$16.845 billion	2.68%	\$1,002,320,000
Mandatory Layer	\$15.845 billion	2.49%	\$ 931,260,000

The FHCF's official bond estimates will be done in October 2007 and more exact numbers can be calculated later.

EXAMPLE: If the FHCF does not offer any TICL coverage, the anticipated maximum annual assessments to all assessable policyholders (all property and casualty policyholders including surplus lines but excluding workers' compensation, medical malpractice, federal flood, and accident & health) would be 2.49% of their premium per year for 30 years (see the Mandatory Layer above). In dollars \$931,269,000 would be collected each year for 30 years.

If the FHCF offers a TICL layer of \$6 billion, the total capacity of the FHCF would be \$21.845 billion and this would result in a 3.63% annual assessment to fund the amount of bonding required. In dollar terms, this represents an annual assessment of \$1,357,620,000 per year for 30 years. This translates to \$426,360,000 (\$1,357,620,000 - \$931,260,000) more assessments each year for 30 years due to the TICL optional coverage being offered.

If the entire \$12 billion TICL layer is offered, the FHCF capacity is \$27.845 billion and the annual emergency assessment is estimated at 4.77% of the assessable premiums for 30 years. The total dollars associated with this assessment is \$1,783,980,000 per year for 30 years. The additional amount due to the TICL coverage is \$852,720,000 (\$1,783,980,000 - \$931,260,000) annually for 30 years.