# HOUSE OF REPRESENTATIVES STAFF ANALYSIS

**BILL #:** PCB JEC 08-01 Florida Hurricane Catastrophe Fund Risk Reduction
**SPONSOR(S):** Jobs & Entrepreneurship Council
**TIED BILLS:** **IDEN./SIM. BILLS:**

| REFERENCE | ACTION | ANALYST | STAFF DIRECTOR |
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| Orig. Comm.: Jobs & Entrepreneurship Council | 10 Y, 0 N | Callaway/Topp | Thorn |
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## SUMMARY ANALYSIS


The Florida Hurricane Catastrophe Fund (FHCF or fund) is a tax-exempt trust fund created in 1993 after Hurricane Andrew as a form of mandatory reinsurance for residential property insurers. All insurers that write residential property insurance in Florida are required to buy reimbursement coverage (reinsurance) on their residential property exposure through the FHCF.

The FHCF is administered by the State Board of Administration (SBA) and is headed by a senior officer who reports directly to the Executive Director of the SBA. The bill changes the oversight of the FHCF. It makes the FHCF a division of the SBA reporting directly to the Governor and Cabinet, rather than to the SBA Executive Director. Similarly, the FHCF will be headed by an executive director that reports directly to the Governor and Cabinet rather than to the SBA Executive Director. Most of the functions that are currently carried out by the SBA are transferred to control of the Division of the FHCF.

House Bill 1A (Ch. 2007-1, L.O.F.) enacted during the January 2007 Special Session allowed insurers to purchase additional coverage from the FHCF above the maximum limits of the mandatory coverage. This option is referred to as Temporary Increase in Coverage Limits (“TICL”), and is available only until May 31, 2010. The TICL options allow an insurer to purchase additional coverage for its share of up to $12 billion, in $1 billion increments, above the mandatory coverage limit.

The bill reduces the TICL additional coverage from $12 billion to $9 billion by eliminating the $10 billion, $11 billion, and $12 billion coverage options. Thus, a maximum of $9 billion in TICL coverage will be offered in addition to the mandatory fund coverage. This reduces the Fund’s risk and exposure by $3 billion annually and reduces the potential assessments Floridians would pay if the FHCF’S maximum obligations were utilized to reimburse hurricane insurance claims paid by insurance companies. The bill also sets the Fund’s reimbursement at 70 percent of the insurer’s losses. Under current law, insurance companies can choose the percentage of losses they absorb (55, 25, or 10 percent) as the law allows the Fund to reimburse insurers 45, 75, or 90 percent of their losses.

The bill does not change the deficit financing or assessment provisions for the FHCF. However, the bill sets the interest owed for delinquent assessment payments by surplus lines agents and policyholders at 9 percent per year, compounded annually and sets penalties for delinquent assessment payment at $500 per day. Under current law, the interest on delinquent assessment payments by surplus lines agents and policyholders is the interest income of the FHCF plus 5 percent.

## FULL ANALYSIS

## I. SUBSTANTIVE ANALYSIS

A. HOUSE PRINCIPLES ANALYSIS:

**Provide Limited Government:** The bill reduces the exposure and risk the state has incurred through the Florida Hurricane Catastrophe Fund.

**Ensure Lower Taxes:** By reducing the state's risk in the FHCF, this bill reduces the potential assessments Floridians would pay if the FHCF's maximum obligations were utilized to reimburse hurricane insurance claims paid by insurance companies.

**Promote Personal Responsibility:** Insurance companies that purchase 90 percent or 75 percent FHCF coverage are required to retain more of the risk for part of the FHCF exposure than under current law.

B. EFFECT OF PROPOSED CHANGES:

### The Florida Hurricane Catastrophe Fund (FHCF)

The FHCF is a tax-exempt trust fund created in 1993 after Hurricane Andrew as a form of mandatory reinsurance for residential property insurers (s. 215.555, F.S.). All insurers that write residential property insurance in Florida are required to buy reimbursement coverage (reinsurance) on their residential property exposure through the FHCF.

The FHCF is administered by the State Board of Administration (SBA)[1] and is headed by a senior officer who reports directly to the Executive Director of the SBA. The bill changes the oversight of the FHCF. It makes the FHCF a division of the SBA reporting directly to the Governor and Cabinet, rather than to the SBA Executive Director. Similarly, the FHCF will be headed by an executive director that reports directly to the Governor and Cabinet rather than to the SBA Executive Director. This proposed organization is modeled on the current Division of Bond Finance, which is housed within the SBA, but reports directly to the Governor and Cabinet. Most of the functions that are currently carried out by the SBA are transferred to control of the Division of the FHCF.

The FHCF is a tax-exempt source of reimbursement to property insurers for a selected percentage (45, 75, or 90 percent) of hurricane losses above the insurer's retention (deductible). It provides insurers an additional source of reinsurance that is significantly less expensive than what is available in the private market; enabling insurers to generally write more residential property insurance in the state than would otherwise be written. The FHCF has historically provided reinsurance at a cost of about 20 to 33 percent of the cost of private reinsurance. Because of the low cost of coverage from the FHCF, the fund acts to lower residential property insurance premiums for consumers. The FHCF must charge insurers the "actuarially indicated" premium for the coverage provided, based on hurricane loss projection models found acceptable by the Florida Commission on Hurricane Loss Projection Methodology.

Insurers must first pay hurricane losses up to their "retention" for each hurricane, similar to a deductible, before being reimbursed by the FHCF coverage. In 2005, legislation addressed multiple storm seasons by providing that the retention is reduced to one-third of the regular retention for a third hurricane and each additional hurricane. The full retention is applied to the two hurricanes causing the greatest losses

[1] Article IV, Section 4(e) of the Florida Constitution established the State Board of Administration as consisting of the Governor (as Chair), the Chief Financial Officer, and the Attorney General who serve as the Board of Trustees for the SBA. Pursuant to s. 19-3.016, F.A.C., the Board of Trustees selects an Executive Director of the SBA, who serves as the chief administrative officer of the SBA. The Board of Trustees delegates authority to the Executive Director to manage the financial affairs of the SBA.

to the insurer. The fund's retention is adjusted annually based on the FHCF's exposure. For the 2007 hurricane season the retention is approximately $6.1 billion for all insurers combined. A retention is calculated for each insurer based on its share of fund premiums.

For the 2007 hurricane season the FHCF will pay a maximum of $15.85 billion for mandatory coverage. This amount may be adjusted annually based on the percentage growth in fund exposure, but cannot exceed the dollar growth in the cash balance of the fund. The maximum coverage amount for each insurer is based on that insurer's share of the total premiums paid to the fund.

**Temporary Increase in Coverage Limits**

House Bill 1A enacted during the January 2007 Special Session allowed insurers to purchase additional coverage from the FHCF above the maximum limits of the mandatory coverage.[2] This option is referred to as Temporary Increase in Coverage Limits ("TICL"), and is available only for the 2007, 2008, and 2009 contract years (until May 31, 2010). The TICL options allow an insurer to purchase additional coverage for its share of up to $12 billion, in $1 billion increments, above the mandatory coverage limit (i.e., increasing maximum limits from $15.85 billion to $27.85 billion in 2007). The law authorized the SBA to further increase the limits by an additional $4 billion, but the SBA did not approve this increase for 2007.

The bill reduces the TICL additional coverage from $12 billion to $9 billion by eliminating the $10 billion, $11 billion, and $12 billion coverage options. Thus, a maximum of $9 billion in TICL coverage will be offered in addition to the mandatory fund coverage. This reduces the Fund's risk and exposure by $3 billion annually and reduces the potential assessments Floridians would pay if the FHCF'S maximum obligations were utilized to reimburse hurricane insurance claims paid by insurance companies. The bill also sets the Fund's reimbursement at 70 percent of the insurer's losses. Under current law, insurance companies can choose the percentage of losses they absorb (55, 25, or 10 percent) as the law allows the Fund to reimburse insurers 45, 75, or 90 percent of their losses. The bill does not changes the expiration of the TICL coverage options and does not change the premium calculation for TICL coverage.

Insurers must pay a premium for the optional TICL coverage. The premium for the TICL options is established by the SBA under the same method it uses for determining "actuarially indicated" premiums for the mandatory FHCF coverage.[3] As historically applied by the SBA, the actuarially indicated premium is the premium that is equal to the estimated average annual loss for the coverage purchased, based on a weighted average of the four hurricane loss models approved by the Florida Commission on Hurricane Loss Projection Methodology, plus the SBA's costs of administration. For the TICL coverage options, the premium is 2.2 percent of the coverage amount, for an insurer electing to buy its full share of the $12 billion TICL limit. This 2.2 percent "rate-on-line" is much less expensive than the premiums charged by private reinsurers, which range from about 10 to 20 percent for this level of coverage. In 2007, insurers took nearly full advantage of the TICL options, purchasing about $11.43 billion of the $12 billion offered, in exchange for a total premium of $242 million.

**Debt Financing and Assessments**

If a hurricane occurs and the cash balance of the FHCF from premiums charged to insurance companies for their FHCF coverage, plus investment income, is not sufficient to cover fund obligations, the FHCF must borrow funds by issuing bonds. To finance the bonds, the SBA must impose emergency assessments on all property and casualty insurance policies (property, auto, liability, etc.), including surplus lines insurance, but excluding workers' compensation, accident and health, medical malpractice, and federal flood insurance. The assessments are collected as equal percentage surcharges to each policyholder's premium for as many years as are necessary to retire the bonds, up to 30 years. The law limits the amount of the assessments to 6 percent of premium annually to finance

[2] s. 215.555(17), F.S. (2007).

[3] s. 215.555(17)(f), F.S., which references s. 215.555(5), F.S.

FHCF losses arising from a single year (i.e., one year's hurricanes), and to 10 percent of premium annually in the aggregate to finance FHCF losses arising from all years. The assessment base for the FHCF was approximately $35 billion for premiums written at year end 2006.

The hurricanes of 2004 and 2005 resulted in $8.45 billion in losses to the FHCF, requiring it to use its entire $7.1 billion in cash reserves and to issue $1.35 billion in bonds for the shortfall. The bonds are currently being financed by a 1 percent of premium assessment, which began January 1, 2007, and is estimated to be levied for six years (through 2012).

The bill does not change the deficit financing or assessment provisions in current law. However, the bill sets the interest owed for delinquent assessment payments by surplus lines agents and policyholders at 9 percent per year, compounded annually and sets penalties for delinquent assessment payment at $500 per day. Under current law, the interest on delinquent assessment payments by surplus lines agents and policyholders is the interest income of the FHCF plus 5 percent. Setting the interest owed at 9 percent will create certainty for surplus lines agents and policyholders as to the amount of interest due.

**Current Financial Status of the FHCF**

The Florida Hurricane Catastrophe Fund has potential reimbursement obligations to insurers of $27.85 billion for the 2007 hurricane season. This amount consists of:

- $15.85 billion of mandatory FHCF coverage, (subject to a growth factor each year);
- $11.43 billion of TICL coverage selected by insurers (of the optional $12 billion offered only for 2007, 2008, and 2009); and
- $557 million selected by insurers eligible to purchase up to $10 million additional coverage (offered only for 2007).

To fully meet the potential $27.85 billion obligation for 2007, the FHCF is relying on:

- $2.08 billion estimated year-end cash balance;
- $6.3 billion in proceeds from pre-event notes that have already been issued (for short-term liquidity needs);
- Up to $25.75 billion in bonds to be issued after a hurricane (which could be used to retire the pre-event notes).

The estimated $2.08 billion cash balance of the FHCF for 2007 is derived from reimbursement premiums collected from insurers for the 2006 and 2007 contract years, for which no hurricane losses have occurred. The year-end cash balance represents the non-debt, cash resources available to pay potential 2007 claims. This balance includes the 2007 FHCF premiums of $1.3 billion, paid by insurers in installments on August 1, October 1, and December 1. The pre-event notes provide additional liquidity of $6.3 billion, which gives the FHCF immediate access to a total of $8.3 billion for paying claims for the 2007 contract year.

If the maximum $25.75 billion of post-event bonds is required, an annual assessment of about 5 percent of premiums would be imposed for 30 years on most property and casualty insurance policies, given current interest levels. In contrast, the bonding required to support the mandatory coverage obligations of $15.85 billion would require an estimated 2.7 percent assessment over 30 years, and a slightly higher assessment of 2.86 percent for 30 years for a subsequent season loss of the same magnitude, both of which are within the assessment cap limits of the FHCF.

The probability of a full $27.85 billion loss (requiring a $25.75 billion bond issue) occurring in any given year is relatively low and would require a hurricane resulting in about $36 billion of insured residential hurricane losses. The probability of this occurring is estimated to be 1.6 percent, or stated differently, a hurricane that occurs about once every 65 years. By comparison, the probability of loss for the full $15.85 billion mandatory coverage is estimated to be 3 percent, or once every 33 years. The probability of any loss at all to the Fund is 13.33 percent, or once every 7.5 years.

Even if the FHCF is required to pay its full 2007 obligations, it will again be liable for its obligations in 2008 and each year thereafter. The mandatory coverage and TICL options in 2008 and 2009 are likely to expose the FHCF to about $27-28 billion in additional obligations for a subsequent season, subject to the limitations of the fund's actual claims-paying (bonding) capacity.

The FHCF estimates its total multiple-years claims paying capacity, as follows:

- $27.83 billion initial season claims paying capacity, consisting of:
  - $2.08 billion cash balance and
  - $25.75 billion bond proceeds.
- $26.37 billion subsequent season claims paying capacity, consisting of:
  - $1.16 billion cash balance,
  - $25.21 billion bond proceeds, and
  - $1.25 billion in reimbursement premiums following the subsequent season.
- Total multiple years claims paying capacity = $55.45 billion.

Paying the total $55.45 billion over multiple seasons would require the maximum allowable 10 percent of premium assessment for 30 years, which also accounts for the 1 percent assessment currently being levied through 2012. The estimated $55.45 billion claims paying capacity is slightly below the maximum obligations of the FHCF for both the initial and subsequent seasons. If the FHCF commits substantially all of its assessment authority to fund bonds, it will thereafter be unable to provide additional reinsurance.

C. SECTION DIRECTORY:

**Section 1:** Amends s. 215.555 relating to the Florida Hurricane Catastrophe Fund.

**Section 2:** Amends s. 215.557 relating to the reports of insured values.

**Section 3:** Amends s. 215.5586 relating to the My Safe Florida Home Program.

**Section 4:** Amends s. 215.5595 relating to the Insurance Capital Build-up Incentive Program.

**Section 5:** Amends s. 627.0628 relating to the Florida Commission on Hurricane Loss Projection Methodology.

**Section 6:** Provides an effective date of July 1, 2008.

## II. FISCAL ANALYSIS & ECONOMIC IMPACT STATEMENT

A. FISCAL IMPACT ON STATE GOVERNMENT:

1. Revenues:

   See Fiscal Comments below.

2. Expenditures:

   See Fiscal Comments below. The change in the oversight of the Florida Hurricane Catastrophe Fund is not expected to have a fiscal impact on the FHCF or the State Board of Administration.

B. FISCAL IMPACT ON LOCAL GOVERNMENTS:

1. Revenues:

   None.

2. Expenditures:

   None.

C. DIRECT ECONOMIC IMPACT ON PRIVATE SECTOR:

The elimination of the top $3 billion of TICL coverage options and the institution of a 70 percent reimbursement level for TICL coverage reduces the risk of loss to the FHCF and, therefore, the risk of assessments to property and casualty insurance policyholders. However, it is also likely to cause rates for residential property insurance to increase in the short-term because insurers will be required to pay higher premiums for replacement coverage from private reinsurers. Representatives from the Department of Financial Services, which supports the legislation, estimate that the premium increase on residential policies would range from 1.5 percent to 2.0 percent, on average. The Office of Insurance Regulation estimates that the premium increase on residential policies would range from 1.6 percent to 3.6 percent, on average.

The DFS representatives estimate that the reduction in risk of loss to the FHCF, due to the reduction in TICL coverage, would potentially save Floridians from paying $184 million in annual assessments, or a total of $5.5 billion over a 30-year period. In terms of assessment percentages, reducing the $12 billion TICL option to $9 billion (which would reduce the amount of bonds potentially required for one year's storms from about $26 billion to $23 billion) would reduce the annual assessment percentage from about 4.77 percent to 4.2 percent for thirty years.

Changing the reimbursement under TICL to 70 percent of hurricane losses, rather than the 90 percent option that most insurers select, further reduces the liability of the FHCF and potential assessments, depending on the magnitude of losses. The state would still be liable for up to $9 billion of reimbursement obligations under TICL, but greater total losses would be required to reach this limit due to the change in the reimbursement percentage.

The $3 billion reduction in the amount of bonds that may be required to fund FHCF obligations increases the ability of the FHCF to issue sufficient bonds to cover its maximum potential liability and to reimburse insurers in a timely manner. This would lessen the need or desire for insurers to purchase private reinsurance to cover the FHCF "credit risk" as estimated by certain insurance rating organizations. This could have a favorable rate impact, depending on the extent to which OIR approves rates that include such expense.

D. FISCAL COMMENTS:

The potential liability of the FHCF is reduced by $3 billion due to the reduction in the optional TICL coverage by this amount. Changing the reimbursement to 70 percent of hurricane losses, rather than the 90 percent option that most insurers select, further reduces the state's obligation, depending on the magnitude of losses. See Direct Economic Impact on Private Sector above. The reductions in coverage will also reduce the premium collected by the FHCF for TICL coverage. The FHCF collected $242 million in additional premium for the entire TICL layer in 2007.

## III. COMMENTS

A. CONSTITUTIONAL ISSUES:

1. Applicability of Municipality/County Mandates Provision:

The mandates provision does not apply because this bill does not: require counties or municipalities to spend funds or to take an action requiring the expenditure of funds; reduce the authority that municipalities or counties have to raise revenues in the aggregate; or reduce the percentage of a state tax shared with counties or municipalities.

2. Other:

None.

B. RULE-MAKING AUTHORITY:

None provided.

C. DRAFTING ISSUES OR OTHER COMMENTS:

The July 1, 2008 effective date would need to be amended to June 1, 2008, or earlier, in order to make the changes effective for the 2008 contract year of the FHCF, which begins on June 1 of each year.

D. STATEMENT OF THE SPONSOR

Not applicable as this is a proposed council bill.

## IV. AMENDMENTS/COUNCIL SUBSTITUTE CHANGES

On February 21, 2008, the Jobs & Entrepreneurship Council heard the bill and reported the bill favorably without amendment.