

Legislative Briefing

An update from the Property Specialty

January 2007

Florida Legislative Update

On January 23rd, Guy Carpenter & Company, LLC and Dowling & Partners Securities, an insurance industry analyst, held a teleconference to discuss Florida's legislative changes with regard to reducing insurance rates for consumers and the implications for the insurance and reinsurance industry. David Priebe, Head of Guy Carpenter's Worldwide Specialty Operations, and VJ Dowling, Managing Partner of Dowling & Partners Securities, participated in the call. A comprehensive report on the legislation was provided by Guy Carpenter's Florida consultant Fred Karlinsky, Esq. of Colodny, Fass, Talenfeld, Karlinsky & Abate.

Background

Hurricane activity in Florida has been a challenge for both the insurance industry and state leaders facing constituents who are concerned about high insurance rates. Soon after Hurricane Andrew ravaged Florida in 1992, lawmakers created two facilities to keep insurance companies from withdrawing from the Florida market. The Florida Hurricane Catastrophe Fund (FHCF) was formed to provide reinsurance to insurers, and Citizens Property Insurance Corporation (Citizens) was created as a state-run insurer of last resort. Both funds were hit especially hard after a series of eight hurricanes swept through Florida in 2004 and 2005.

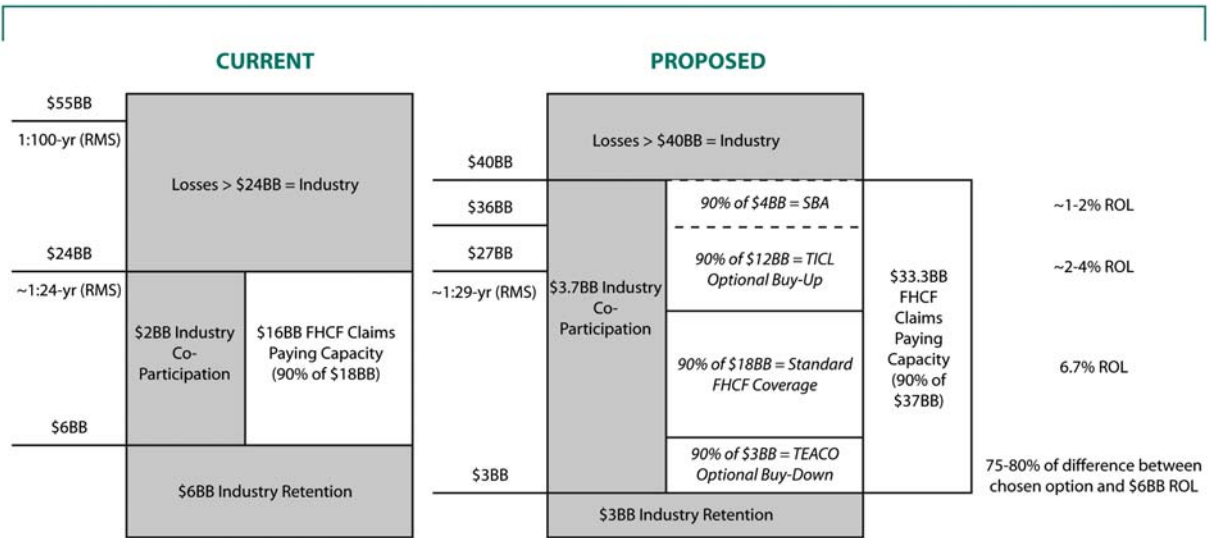
Recent Developments

Soon after taking office on January 1, 2007, Florida Governor Charlie Crist called the state legislature into special session to address the high cost of insurance in the state. (Crist and many other lawmakers had pledged during the 2006 election campaigns to reduce insurance costs.) On January 22, the Florida State House and Senate passed a bill aimed at reducing hurricane-related insurance costs for Florida homeowners and businesses. The legislation, which passed unanimously in the Senate and by a vote of 116-2 in the House, makes considerable changes to both the FHCF and Citizens.

Changes to the FHCF

The changes to the FHCF were especially significant. In order to reduce consumer rates, lawmakers expanded the ceiling of industry losses that would be covered by the FHCF to 90 percent of \$37 billion in excess of \$3 billion (increased from 90 percent of \$18 billion in excess of \$6 billion). That effectively doubles the aggregate covered by the state fund from \$16 billion to \$33 billion. The law allows private insurers to buy reinsurance from the FHCF at below-market rates. Insurers that purchase cover from FHCF will be required to take a mandatory "oath of truth" to pass the savings on to their customers. The costs for the expansion are to be covered by premiums as well as post event bonding, meaning in effect that the law lowers rates now in exchange for potential increases in years to come.

Current & Proposed 2007 FHCF Structure



Source: IBNR Weekly #3 1/22/07.

As a result of the FHCF expansion, reinsurers stand to lose approximately \$1.5 billion to \$2 billion in premiums, which would come out of a worldwide market estimated to be approximately \$10 billion to \$12 billion. This will impact reinsurers' profitability. Florida generates high expected profits due to the extreme volatility inherent in the state. The risks are huge so the rewards can be larger as well. As reinsurers seek to replace this revenue, increased competition is expected across other reinsurance lines.

Changes to Citizens

Citizens will no longer be required to charge the highest insurance rates in an area. The requirement that they charge rates sufficient to purchase reinsurance up to specified PML's has been eliminated. The last two Citizens rate increases have been rolled back, and the current rate will be frozen at year-end 2006 levels. Citizens has been given a rate structure and product expansion that makes it the most competitive insurance offering in the state. The market share, which currently stands at about one-third of the total market, is expected to increase dramatically as a result. Citizens is also:

- Likely to begin writing multi peril coverage in the high risk areas.
- Entering the commercial lines market through the assumption of the Property and Casualty JUA.

Additional Legislative Changes

- Higher reserves now required for pup companies (independent Florida entities set up by and capitalized separately from national insurance companies).
- Prohibition of “cherrypicking.” (If an insurer sells a type of insurance in another state, it must offer it in Florida in order to do any business in the state.)
- Suspension of “file and use” provision that allows insurers to file rates and use them immediately. This measure demonstrates the state may be moving toward a prior-approval system.
- Elimination of building-code exemptions in the Panhandle region of the state.
- Removal of regulatory barriers to risk pooling among similar entities, such as hospitals, municipalities and condominium associations, allowing them to self-insure.
- Elimination of collateral requirements for non-U.S. insurers. While the National Association of Insurance Commissioners voted in December 2006 to remove these requirements, Florida is the first state to do so and represents a major change for those insurers.

Conclusion

This legislation has far reaching implications for both insurers and reinsurers operating in Florida. From an insurance company perspective, there is a dominant competitor on the scene in the form of Citizens. While the implications in the commercial market are less clear, the 33% Citizen’s residential market share will undoubtedly grow. The questions are only: How big?" and "How fast?". Reinsurance is being provided at extremely low rates through the FHCF but that coverage is not without potential problems. There are questions about the states ability to generate adequate bonding to fund losses. As a result, there are concerns about credit worthiness of the reinsurance and the liquidity associated with payments and assessments. The coverage is also an aggregate limit which will only respond to one major (\$40B residential loss or greater) event. Subsequent event capacity needs to be explored by insurers and the ability to secure subsequent season capacity to reconstruct their limit is a problem that the FHCF will need to solve. For reinsurers the impact is less kind. They will lose substantial premium volume, they will lose the profit potential in that high risk/reward market segment and they will have excess capital that needs to be deployed elsewhere. All of those factors will likely put downward rate pressure on other geographic segments of the reinsurance market and other lines of business.

Guy Carpenter will work closely with clients to quantify the impact of the legislation, examine and model their exposures and work out the best possible risk management strategy. It will also assist clients in taking advantage of opportunities for newly available capital. In addition, Guy Carpenter is looking into issues of increased supply and reduced demand in the reinsurance market, credit exposure and the development of credit enhancement solutions, coverage against the possibility of a second major event in Florida and wraps around the FHCF. As the Florida market evolves, Guy Carpenter will continue to monitor developments and communicate updates to clients and reinsurers.

If you have any questions, please contact Timothy Gardner, Property Specialty Practice Leader (917-937-3465).

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