Why hard cash beats hope any day

Florida may be an exceptional case — but as **David Spiller** argues, nothing distributes large risks around the globe as efficiently as support from the reinsurance market

David Spiller is president and chief executive of Guy Carpenter.

Who among us does not empathise with hurricane-battered Floridians? Florida homeowners have seen 20-plus percent rate increases on their homeowners' insurance bills in recent years, and the average premium in Florida is now about double the average for the nation as a whole.

Early forecasts predict yet another 'above average' windstorm season for the Sunshine State. With experts saying the region is in the midst of a cycle that will increase both the frequency and severity of storms for decades to come, it is no surprise that the state's homeowners are ready to leap at any relief in sight. It's also no surprise that lawmakers and politicians have seized the cause with gusto.

As a result, earlier this year, Florida's new governor signed into law a bill that aims to reduce homeowners' insurance rates for constituents on this vulnerable sub-tropical peninsula. The legislation is long and detailed, but given space constraints, I will restrict my comments to the provisions dealing with the Florida Hurricane Catastrophe Fund (FHCF), the state-run reinsurer.

The law significantly expands the cover provided by the FHCF. Private insurers can now buy increased limits of reinsurance from the fund at below-market rates, but are obligated via new filings to pass on the savings to their homeowners' policyholders. Policyholders enjoy cheaper insurance, with losses to be covered by the limited resources of the FHCF and post-event issuance of bonds.

Only time will tell how successful the legislated solution will be. Also unclear is exactly how much savings consumers will garner, and when. It is obvious at the onset that the new measure is markedly different from the time-tested mechanism the modern world has cultivated for managing catastrophic property losses, the global insurance and reinsurance markets.

Differences

Among the major differences are the following:

1) Putting off until tomorrow.
Florida's new law reduces current insurance costs by providing lower-cost reinsurance supported by debt, which will have to be repaid at some future date by practically all Floridians. This 'play now, pay later' strategy is contrary to the basic premise of insurance, which allows one to pre-pay to transfer risk and assume no payback obligation.

The potential tab is not one to be taken lightly. Consider a loss of 'just' $20bn shared by Florida's seven million households: the tally would be approximately $5200 per household, including interest. And that represents the debt created from only one storm. If there were more major storms over the next few years, the FHCF could be forced to issue its maximum debt of about $56bn, an amount close to three times the state's total debt of $22bn.

2) Not spreading risk globally.
Rather than transfer the risk globally, Florida's legislation transfers risk locally. When the risk of loss is spread to the entire (re)insurance industry, capital flows in from around the world in the wake of an event to rebuild and resuscitate the local economy.

Indeed, there is something comforting about a global safety net that keeps the local economy from sinking too low after a large-scale event and helps it to bounce back. With large hurricane losses in Florida now paid partly by issuing debt, the burden of future losses will rest squarely on Florida's shoulders alone for many years to come.

3) Relying on cross subsidies.
Under Florida's new plan, capital to pay back the bonds that are issued following a large homeowners' loss will be raised though surcharges on most property and casualty insurance lines.

Hence, the cost of losses will be born by other Floridians, from the senior citizen on a fixed income to the flower-shop owner on the corner of Main Street, simply because they buy insurance — say, an auto-insurance policy in the case of the senior citizen and a Business Owners Policy (BOP) purchased by the florist. Regardless of the individual's exposure level or loss experience, they will pay more.

4) It sends the wrong signals.
By making insurance for high-risk coastal properties more costly and less available, the global (re)insurance industry helps keep development in high-risk areas in check. The legislation reduces obstacles to 'building bigger' in harm's way.

Without insurance-market disincentives, coastal property values and population may grow at an even more accelerated pace than they are already, taking potential damages to new heights.

Lingering questions

Will Florida's new legislation provide an effective net? This and other questions linger. Might the new legislation make insurers cautious about entering the Florida market at all, thereby having a cascading effect on other lines of insurance? Could the weather buck predictions and give the FHCF the luxury of even a few relatively benign hurricane seasons to shore up its capital base better before another large-scale event?

For the sake of Floridians, we hope the weather stays mild and the legislation succeeds. Therein lies another difference: a strong capital base beats hope any day. re

reinsurance

Editorial
Editor Mark Geoghegan
Reporter Mairi MacDonald
Sub-editor Jane Cahane
Art director Nicky Brown
Editor-in-chief Antony Gould
Editorial tel +44 (0) 20 7484 9933
Editorial fax +44 (020) 7484 9900
E-mail addresses name.surname@incisivemedia.com

Advertisement sales
Publisher Jonathan Trinder
Sales manager Graeme Roche
Advertising tel +44 (0)20 7484 9942
Advertising fax +44 (0)20 7484 9992
name.surname@incisivemedia.com

Incisive Media
Chief operating officer James Hanbury
Group editorial services director David Worsfold
Managing director, insurance division Graham Harman
Marketing manager Ro Osborne
Group production manager Lorna Graham

Customer services
Tel (UK) +44 0870 240 8859
Tel (US) +1 (212) 925 6990
E-mail cs@incisivemedia.co.uk

Subscription hotline
Tel +44 (0)20 8606 7516
Fax +44 (020) 8606 7303
Email sigs@wdis.co.uk

Annual subscriptions: UK £225 Airmail Europe £242 (€357) Airmail RoW £272 (€402). Remittances by cheque or international money order to be sent with order and made payable to Incisive Financial Publishing Ltd. Overseas cheques should be drawn in sterling.

Head office
Incisive RWG Ltd, Haymarket House, 28–29 Haymarket, London SW1Y 4RX
Tel +44 (0)20 7484 9700
US & Canada office
Incisive RWG Inc , 270 Lafayette Street, Suite 700, New York, New York 10012, US
Tel +(212) 925 6990
Asia & Pacific office
Incisive RWG Ltd, Unit 2708, 27th Floor, The Centre, 99 Queen's Road, Central, Hong Kong, SAR China
Tel +(852) 2545 2710

Average net circulation from 01/07/2005 to 30/06/2006: **9,298**

An incisivemedia plc publication

ISSN 0048-7171
Reproduction: CTT, London
Printer: The Grange Press, Southwick
Member of the Audit Bureau of Circulations