

HOUSE OF REPRESENTATIVES STAFF ANALYSIS

BILL #: CS/HB 391 Florida Hurricane Catastrophe Fund

SPONSOR(S): Insurance & Banking Subcommittee; Hager

TIED BILLS: **IDEN./SIM. BILLS:**

REFERENCE	ACTION	ANALYST	STAFF DIRECTOR or BUDGET/POLICY CHIEF
1) Insurance & Banking Subcommittee	13 Y, 0 N, As CS	Callaway	Cooper
2) Government Operations Appropriations Subcommittee			
3) Regulatory Affairs Committee			

SUMMARY ANALYSIS

The Florida Hurricane Catastrophe Fund (FHCF or Fund) is a tax-exempt trust fund created in 1993 as a form of reinsurance for residential property insurers. For solvency reasons, property insurers are required by the Office of Insurance Regulation (OIR) to purchase a certain amount of reinsurance. The amount of reinsurance purchased varies from insurer to insurer and is based on an insurer's financial situation and exposure.

The FHCF sells reinsurance to property insurance companies significantly cheaper than reinsurance sold by private reinsurance companies. Each insurance company writing insurance policies covering residential property or any policy covering a residential structure or its contents must participate in the FHCF. The Fund, which is administered by the State Board of Administration, reimburses insurers for a portion of their hurricane losses to residential property above the insurer's retention (deductible). The deductible on reinsurance sold by the Fund is set by statute and the maximum amount the Fund reinsures (the Fund coverage) is also set by statute.

Starting June 1, 2015, the bill restructures the FHCF to reduce the exposure of the Fund by reducing the maximum coverage of the FHCF from \$17 billion to \$14 billion. However, each year, the bill gives insurers the option to buy a maximum of \$3 billion in additional coverage from the Fund, in \$1 billion increments, above the \$14 billion maximum coverage level. The \$3 billion in additional coverage is the aggregate amount of additional coverage available and each insurer purchasing additional coverage can purchase its share of the coverage. The amount of the insurer's share of the additional coverage is determined the same way as their share of the mandatory coverage is determined.

Whether the changes to the FHCF made by the bill increase property insurance rates depends on how much of the additional \$3 billion in FHCF coverage is purchased. Property insurance rate increases occur if not all of the \$3 billion optional coverage is purchased because reinsurance purchased from the FHCF costs one-fourth to one-third less than reinsurance purchased from private reinsurance companies. Insurers who choose not to buy any of the additional \$3 billion in FHCF coverage, or who buy only part of the \$3 billion, will replace the optional FHCF reinsurance with more expensive reinsurance bought from private reinsurers and the insurer's increased reinsurance costs will be passed through to homeowners in rates.

The estimated rate impact of the bill is: 0% rate increase if all (\$3 billion) of the optional \$3 billion is bought by insurers, 0.8% rate increase if \$2 billion is bought, 1.6% rate increase if \$1 billion is bought, and 2.4% rate increase if none (\$0 billion) is bought.

The bill may have additional fiscal impacts on the private sector as outlined in the Fiscal Analysis section of the staff analysis. The bill has no fiscal impact on state or local governments.

The bill is effective upon becoming a law.

FULL ANALYSIS

I. SUBSTANTIVE ANALYSIS

A. EFFECT OF PROPOSED CHANGES:

Background on the Florida Hurricane Catastrophe Fund

The Florida Hurricane Catastrophe Fund (FHCF or Fund) is a tax-exempt trust fund created in 1993 as a form of reinsurance for residential property insurers.¹ The purpose of the FHCF is to protect and advance the state's interest in maintaining insurance capacity in Florida by providing reimbursements to insurers for a portion of their catastrophic hurricane losses.

The FHCF sells reinsurance to property insurance companies significantly cheaper than reinsurance sold by private reinsurance companies. It is estimated that coverage purchased through the FHCF costs insurers one-fourth to one-third what it would cost in the private reinsurance market.² There are several reasons for these cost savings:³

1. The FHCF operating cost is less than 1% of the annual premium collected, whereas, the operating costs for private reinsurance can range from 10% to 15% of the premium collected.
2. The FHCF does not pay reinsurance brokerage commissions.
3. The FHCF has no underwriting costs.
4. The FHCF is a tax-exempt entity that does not pay federal income taxes or state taxes.
5. The FHCF has the ability to issue tax-exempt debt which results in lower financing costs should it become necessary to finance losses with revenue bonds.
6. The FHCF does not include a factor for profit for reinsurance sold by the FHCF.
7. The FHCF does not include a risk load for reinsurance sold by the FHCF.

Each insurance company writing insurance policies covering residential property or any policy covering a residential structure or its contents must participate in the FHCF. (s. 215.555(4)(a), F.S. and s. 215.555(2)(c), F.S.). Residential property is defined in s. 627.4025(1), F.S., to include personal lines and commercial lines residential coverage. This coverage includes the following insurance policies: homeowner's, mobile homeowner's, dwelling, tenant's, condominium unit owner's, condominium association, cooperative association, and apartment building.

The FHCF is administered by the State Board of Administration and reimburses property insurers for a selected percentage (45, 75, or 90%) of hurricane losses to residential property above the insurer's retention (deductible).⁴ The amount of hurricane losses the FHCF will not reimburse (45, 25, or 10%) is the insurer's co-pay for FHCF reinsurance. Insurers finance the co-pay with funds from insurance premiums paid by homeowners or with private reinsurance. Most property insurers select the 90% coverage level, meaning the FHCF will reimburse the insurer 90% of the insurer's specified hurricane losses with the insurer paying the remaining co-pay of 10% from other sources.

A reimbursement contract between the FHCF and the property insurer governs an insurer's participation in the FHCF and the percentage of the insurer's reimbursement. Reimbursement contracts run from June 1st–May 30th. The current contract year (2013-2014 contract year) runs from June 1, 2013–May 30, 2014.

The FHCF must offer two options for reinsurance coverage for all residential property insurers. One of the two options is mandatory and thus must be purchased by all insurers on their residential property exposure. The voluntary coverage option, Temporary Increase In Coverage Limit Options (TICL), offers reinsurance to insurers above the mandatory coverage.

¹ s. 215.555, F.S. The FHCF was created after Hurricane Andrew in 1992.

² Annual Report of the Florida Hurricane Catastrophe Fund Fiscal Year 2011-2012, p. 16, available at <http://www.sbafla.com/fhcf/Home/FHCFReports/tabid/315/Default.aspx> (last viewed December 20, 2013).

³ Annual Report of the Florida Hurricane Catastrophe Fund Fiscal Year 2011-2012, p. 16, available at <http://www.sbafla.com/fhcf/Home/FHCFReports/tabid/315/Default.aspx> (last viewed December 20, 2013).

⁴ Retention is defined to mean the amount of losses below which an insurer is not entitled to reimbursement from the Fund. A retention is calculated for each insurer based on its proportionate share of Fund premiums.

For the mandatory coverage, the FHCF charges insurers the “actuarially indicated” premium for the coverage provided by the FHCF, based on hurricane loss projection models found acceptable by the Florida Commission on Hurricane Loss Projection Methodology. Each insurer’s premium amount for mandatory coverage is different because the premium is based on the insured value of the residential property the insurer insures, the location of the property insured, the construction type of the property insured, the deductible amounts for the property insured, and other factors. The premium for mandatory coverage also includes a cash build-up factor which is charged on top of the actuarially indicated premium. For the 2013-2014 contract year, the cash build-up factor is 25%, meaning an insurer’s premium is 25% greater than the actuarially indicated premium. By law, the cash build-up factor will remain at 25% for all future years.

Florida law sets the maximum amount the FHCF reimburses insurers each year for the mandatory coverage.⁵ This is the FHCF’s capacity. Under current law, the FHCF’s capacity is \$17 billion for each contract year. The capacity does not increase until the FHCF’s cash and bonding ability exceeds \$34 billion. This allows the FHCF to accumulate funds to pay the maximum mandatory coverage FHCF obligations (\$17 billion a year) for claims resulting from hurricanes in back-to-back seasons.⁶ Once a \$34 billion funding level is reached by the FHCF, the FHCF’s capacity will increase. The method for calculating the Fund’s capacity under current law allows the FHCF’s cash balance to grow in years where there are no hurricanes while keeping the FHCF’s exposure (capacity) frozen so that the FHCF is less reliant on bonding to meet its mandatory coverage obligations. For the current contract year, the insurance industry as a whole is covered for losses up to \$17 billion by the mandatory coverage.

Before FHCF monies are available to pay claims each insurer must meet a retention/deductible. The retention amount for each insurer is different because the amount is based on the amount of premium the insurer pays to the FHCF. For the 2013-2014 contract year, the insurance industry as a whole has an aggregate retention of \$7.213 billion for mandatory coverage, meaning the total of all individual insurer retentions/deductibles will total \$7.213 billion per hurricane event if all participating insurers reached their retention. Although the insurance industry’s aggregate deductible/retention totals \$7.213 billion, insurers can obtain reimbursement from the FHCF before the insurance industry losses total \$7.213 billion because loss recovery from the FHCF is based on an individual insurer meeting its own retention for mandatory coverage prior to losses being reimbursed.

The TICL options were added to the FHCF in 2007.⁷ The purchase of these options is voluntary and, if purchased, provides the insurer a share of additional coverage above the mandatory FHCF coverage in \$1 billion increments. When the TICL options were created in 2007, \$12 billion of additional FHCF coverage was available for purchase. However, due to statutory reductions in TICL options available, for the 2013-2014 Fund contract year, the last year TICL coverage is available, only \$2 billion is available for purchase.⁸ Of the \$2 billion available in TICL coverage, \$207,280 was purchased by insurance companies.

For the 2013-14 contract year (June 1, 2013–May 31, 2014), the maximum amount the FHCF would have to reimburse insurers is \$17.0002 billion, allocated as follows:

- \$17 billion for the mandatory coverage.
- \$207,208 for the TICL coverage option.⁹

To fund its obligations of \$17.0002 billion the FHCF has \$9.764 billion in cash.

Because the obligations of the FHCF exceed its cash on hand by approximately \$7.24 billion, if the FHCF had to pay its maximum actual obligations of \$17.0002 billion this contract year, it would have to bond for \$7.24 billion to have enough money to pay claims. The Fund already has \$2 billion in pre-event bonds that will be used to pay claims during this contract year. After accounting for these bonds,

⁵ s. 215.555(4)(c)1., F.S.

⁶ The funds may be accumulated from premiums and bonding.

⁷ Ch. 2007-1, L.O.F.

⁸ Under current law, the maximum amount of TICL coverage offered for purchase by the FHCF decreases by \$2 billion each contract year.

⁹ Report of Claims-Paying Capacity Estimates dated October 15, 2013, available at

<http://www.sbafla.com/fhcf/BondingProgram/BondingCapacityAnalysisReports/tabid/318/Default.aspxlast> (last accessed December 20, 2013).

the Fund must bond for \$5.24 billion this year. In October 2013, the Fund estimated it could borrow \$6.1 billion through bonding, which is more than the \$5.24 billion needed.¹⁰ Thus, it is anticipated that the Fund has sufficient resources from cash and bonding to pay its obligations in the current contract year.

Revenue bonds issued by the FHCF to pay claims when the FHCF's funds are inadequate are funded by emergency assessments on property and casualty policyholders.¹¹ The FHCF is authorized to levy emergency assessments against all property and casualty insurance premiums paid by policyholders (other than workers' compensation, accident and health, federal flood and, until May 31, 2016, medical malpractice), including surplus lines policyholders, when reimbursement premiums and other FHCF resources are insufficient to cover the FHCF's obligations.¹² Annual assessments are capped at 6% of premium with respect to losses from any one year and a maximum of 10% of premium to fund hurricane losses from multiple years.¹³ Revenue bonds issued by the FHCF may be amortized over a term up to 30 years. Thus, the FHCF may levy assessments for as long as 30 years.

Currently, the FHCF is levying an assessment of 1.3% of premium against all property and casualty insurance policyholders subject to the assessment.¹⁴ Typically, insurers pass this assessment directly to policyholders. The current FHCF assessment is due to a deficit in the Fund associated with the 2005 hurricanes. This is the first assessment the FHCF has had to levy to cover a deficit since its creation in 1993. The current assessment of 1.3% will be levied until December 31, 2016.

Effect of Proposed Changes

The bill restructures the FHCF. Starting June 1, 2015, the bill reduces the limit of the FHCF mandatory coverage from the current \$17 billion to \$14 billion, but gives insurers the option to purchase their share of additional coverage above the mandatory coverage limit of \$14 billion in \$1 billion increments up to \$17 billion. The optional \$3 billion coverage created by the bill is called "CLIO," Coverage Limit Increase Option and must be offered by the Fund each year.

The price of the additional \$3 billion in coverage sold above the \$14 billion mandatory coverage is the same as the actuarially indicated premium for the reinsurance sold for the mandatory coverage. Insurers have the same co-pay options (45%, 25%, or 10%) for the additional coverage that they have for the mandatory coverage.

Providing additional FHCF coverage above the mandatory coverage in \$1 billion increments is similar to the TICL option created in 2007 that expires on May 31, 2014. However, the price of the additional coverage created by the bill is significantly cheaper than the price of TICL coverage which increased each year from 2009 to 2013 and ended in 2013 with TICL costing six times what the FHCF mandatory coverage cost.¹⁵

Current law allowing the FHCF limit to increase to more than \$17 billion only if the FHCF has enough funding to fully fund a \$17 billion single season and a \$17 billion second season capacity (a total of \$34 billion in funding) is amended by the bill to conform to the reduction of the limit to \$14 billion. Thus, the FHCF limit can increase to more than \$14 billion only if the FHCF has enough funding to fully fund a \$14 billion single season and a \$14 billion second season capacity (a total of \$28 billion in funding).

The bill also repeals current law authorizing the TICL option because that option expires by operation of law on May 31, 2014 and contracts between the Fund and insurers purchasing the TICL option until May 31, 2014 have already been executed.

B. SECTION DIRECTORY:

¹⁰ https://www.flrules.org/Gateway/View_notice.asp?id=13718436 (last accessed November 18, 2013).

¹¹ s. 215.555(6)(a)1., F.S.; s. 215.555(6)(b)1., F.S.

¹² s. 215.555(6)(b)1., F.S.; s. 215.555(6)(b)(10), F.S.

¹³ s. 215.555(6)(b)2., F.S.

¹⁴ A 1% assessment was levied and paid by insurers from January 1, 2007–December 31, 2010. The 1% assessment was increased to 1.3% on January 1, 2011 due to increasing losses from the 2005 hurricanes.

¹⁵ s. 215.555(16)(f), F.S.

Section 1: Effective June 1, 2015, amends s. 215.555, F.S., relating to the Florida Hurricane Catastrophe Fund.

Section 2: Provides an effective date of upon becoming a law.

II. FISCAL ANALYSIS & ECONOMIC IMPACT STATEMENT

A. FISCAL IMPACT ON STATE GOVERNMENT:

1. Revenues:

None.

2. Expenditures:

None.

B. FISCAL IMPACT ON LOCAL GOVERNMENTS:

1. Revenues:

None.

2. Expenditures:

None.

C. DIRECT ECONOMIC IMPACT ON PRIVATE SECTOR:

Reducing the mandatory coverage of the FHCF by \$3 billion and providing insurers the option to buy back that \$3 billion in reinsurance from the FHCF can result in increased property insurance rates for homeowners, if all other costs to the insurer factored into rates are static.

For solvency reasons, property insurers are required by the OIR to purchase reinsurance.¹⁶ The amount of reinsurance to be purchased varies from insurer to insurer and is based on an insurer's financial situation and exposure. Reinsurance purchased from the FHCF is considerably cheaper than reinsurance purchased from private reinsurance companies. It is estimated that coverage purchased through the FHCF costs insurers between one-fourth to one-third what it would cost in the private reinsurance market.¹⁷ Reducing the mandatory coverage layer of the FHCF from \$17 billion to \$14 billion requires those property insurers that do not buy their full share of the \$3 billion in optional FHCF reinsurance to replace that share with more expensive reinsurance bought from private reinsurers. The increased reinsurance costs will be passed through to homeowners in rates.¹⁸

According to the OIR, the rate impact of the bill is as follows:

- \$3 billion of the optional \$3 billion is bought by insurers: 0.0% rate increase
- \$2 billion of the optional \$3 billion is bought by insurers: 0.8% rate increase
- \$1 billion of the optional \$3 billion is bought by insurers: 1.6% rate increase
- \$0 billion of the optional \$3 billion is bought by insurers: 2.4% rate increase

The reason there is no rate impact if all insurers bought an additional \$3 billion in FHCF coverage is because that selection would essentially make the maximum coverage for the FHCF \$17 billion, which is the current coverage limit.

¹⁶ The amount of reinsurance required to be purchased varies from insurer to insurer and is based, in part, on the insurer's exposure and funds on hand to pay claims.

¹⁷ Annual Report of the Florida Hurricane Catastrophe Fund Fiscal Year 2011-2012, p. 16, available at <http://www.sbafla.com/fhcf/Home/FHCFReports/tabid/315/Default.aspx> (last viewed December 20, 2013).

¹⁸ Section 627.062(2)(b), F.S. requires the OIR to consider reinsurance costs when reviewing a rate filing for approval. Section 627.062(2)(k), F.S., allows insurers to make an expedited rate filing in order to change rates based solely on reinsurance costs.

Reducing the size of the FHCF could increase the likelihood homeowners will have their property insurance claims paid in a timely manner following a hurricane. If the FHCF has a bonding shortfall after a hurricane, then the FHCF may have to reimburse insurers at a slower pace while the Fund seeks additional funds to reimburse insurers through bonding. If this happens, property insurers may take longer to pay policyholders' claims as some of the funds they likely rely on to pay these claims of are derived from their receipt of reimbursements from the FHCF. The Fund does not project a bonding shortfall for the 2014 hurricane season, so this impact is unlikely this year.

If not all of the \$3 billion in optional coverage is purchased, the total potential obligations of the Fund are reduced. Reduction of the potential obligations of the Fund also reduces the likelihood and amount of a deficit in the Fund which, in turn, reduces the likelihood and amount of assessments that the Fund could levy on property and casualty policyholders.

D. FISCAL COMMENTS:

None.

III. COMMENTS

A. CONSTITUTIONAL ISSUES:

1. Applicability of Municipality/County Mandates Provision:

Not applicable. This bill does not appear to: require counties or municipalities to spend funds or take an action requiring the expenditure of funds; reduce the authority that counties or municipalities 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 by the bill.

C. DRAFTING ISSUES OR OTHER COMMENTS:

None.

IV. AMENDMENTS/ COMMITTEE SUBSTITUTE CHANGES

On March 5, 2014, the Insurance & Banking Subcommittee considered a proposed committee substitute and reported the proposed committee substitute favorably with a committee substitute.

The proposed committee substitute made the following changes to the filed version of the bill:

- Reduced the limit of the FHCF mandatory coverage from the current \$17 billion to \$14 billion starting June 1, 2015, but gave insurers the option to purchase their share of additional coverage above the mandatory coverage limit of \$14 billion in \$1 billion increments up to \$17 billion. The filed bill reduced the limit by \$1 billion a year for three years starting June 1, 2015 and did not provide optional coverage up to \$17 billion.
- Removed the provision in the filed bill allowing certain reinsurance costs related to the FHCF to be included in rate filings.

The staff analysis was updated to reflect the committee substitute.