SENATE STAFF ANALYSIS AND ECONOMIC IMPACT STATEMENT

(This document is based on the provisions contained in the legislation as of the latest date listed below.)

BILL: CS/SB 2556

SPONSOR: Banking and Insurance Committee and Senator Posey

SUBJECT: Florida Hurricane Catastrophe Fund

DATE: April 3, 2003 REVISED: ________ ________ ________ ________

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	Deffenbaugh	Deffenbaugh	BI	Favorable/CS
2.			GO	
3.			FT	
4.			AGG	
5.			AP	
6.				

I. Summary:

The Florida Hurricane Catastrophe Fund ("FHCF" or "fund") was created after Hurricane Andrew as a form of mandatory reinsurance for residential property insurers. The fund is administered by the State Board of Administration (SBA) and is a tax-exempt source of reimbursement to property insurers for a selected percentage of hurricane losses above the insurer's retention (deductible). The insurer's retention is increased annually by the percentage increase in the fund's exposure (due to increased property value or coverage changes). The fund derives its revenue from actuarially determined "reimbursement premiums" paid by insurers. It also has the ability to levy assessments against all property/casualty insurance premiums (other than workers' compensation) when reimbursement premiums and other fund resources are insufficient to cover the fund's obligations. Annual assessments (which have never been levied) are capped at 4 percent of premium with respect to losses from any one storm season and a maximum of 6 percent of premium to fund multiple year storms. Payouts to insurers are capped at $11 billion for losses from any one storm season, with provision for a higher initial season cap after the fund is capable of paying $22 billion to cover losses from two storm seasons. By providing an additional source of reinsurance to what is available in the private market, the law enables insurers to write more residential property insurance in the state than could otherwise be written, and since it is significantly less expensive than private reinsurance, it also acts to lower residential property insurance premiums for consumers.

The bill does the following:

Increases the annual limit of FHCF payments by increasing both the initial and subsequent season coverage limit, based at $11 billion, to grow annually by the same percentage as the fund's exposure to losses (due to increased property value or coverage changes). This would be

the same growth factor as currently applies to the annual increase in each insurer's retention or deductible.

Increases the maximum annual amount of emergency assessments against property/casualty insurers, from 4 to 5 percent for any single year's storms, and from 6 to 8 percent for multiple-year storms, in order to fund the extra capacity described above.

The above changes are designed to provide insurers with a relatively constant layer of reinsurance, which grows by the same amount as exposure to losses grow, and which is more likely to be maintained the year following a storm season that triggers fund losses. By doing so, the property insurance market should be further stabilized, particularly after a major hurricane.

Includes surplus lines policies in the fund's assessment base - Emergency assessments, if levied, would apply to surplus lines policies. The assessments would be made on surplus lines policyholders and collected by the Florida Surplus Lines Service Office to be remitted as directed by the fund.

Other changes:

- Clarifies which year's investment income is used to establish the maximum amount that may be appropriated by the Legislature from the fund for hurricane loss mitigation purposes, which would be the most recent fiscal year for which there are year-end audited financial statements.

- Increases the exposure limit from $500,000 to $3 million for allowing insurers to be exempt from the fund.

- Broadens the selection of reinsurers from which the fund may purchase reinsurance by allowing the purchase of reinsurance from reinsurers acceptable to the Office of Insurance Regulation rather than being limited to the purchase of reinsurance from a reinsurer approved under s. 624.610, F.S.

- Provides specific rulemaking authority to the SBA to exclude certain covered policies that require individual ratemaking. The bill also provides rulemaking authority to allow for the charging of interest on late payments by insurers.

- Other technical and conforming changes.

This bill substantially amends section 215.555 of the Florida Statutes:

II. Present Situation:

Background and Purpose of the Florida Hurricane Catastrophe Fund - In the aftermath of Hurricane Andrew, in a Special Session in November 1993, the Legislature created the Florida Hurricane Catastrophe Fund to provide a mandatory form of reinsurance for residential property insurers in the state.[1] The law was designed to provide additional reinsurance capacity to enable insurers to continue to write residential property insurance in the state. The FHCF is administered by the State Board of Administration (SBA) and is a tax-exempt source of reimbursement to property insurers for excess losses due to hurricanes. By providing an additional source of reinsurance to what is available in the private market, the law enables insurers to write more residential property insurance in the state than could otherwise be written, and since it is significantly less expensive than private reinsurance, it also acts to lower residential property insurance premiums for consumers.

Premiums Charged to Insurers for Fund Coverage - The SBA is required to enter into a reimbursement contract with each residential property insurer, and to establish the premiums that insurers must pay for their coverage from the fund. In doing so, the SBA must select an independent consultant to develop a formula for determining the actuarially indicated premium and must be approved by unanimous vote of the SBA.. Hurricane loss projection models found to be accurate and reliable by the Florida Commission on Hurricane Loss Projection Methodology must be used by the FHCF in establishing its premiums.[2] The annual premium charged to insurers generally represents the average annual expected hurricane loss to be paid by the fund, plus annual administrative expenses of the SBA in operating the fund, and annual legislative appropriations made from the fund for hurricane loss mitigation purposes, the total of which is then discounted to present value based on anticipated investment income.

The premiums that insurers are required to pay the FHCF are significantly lower than comparable levels of reinsurance in the private market, primarily due to its tax-exempt status, low administrative costs, and lack of any profit or risk-load factor in its rates (which are “pure loss cost” rates, based on model projections, plus operating expenses). The SBA estimates that coverage from the FHCF costs insurers between one-quarter to one-third of what it costs in the private market. As such, the FHCF acts to lower premiums for residential property insurance as well as to expand reinsurance capacity, which enables a greater amount of insurance to be written in the state than could otherwise be written if the fund did not exist.

Emergency Assessments - If the fund balance of the FHCF, derived from its premium and investment income, is insufficient to pay its obligations to insurers in any given year, the fund may issue revenue bonds or incur other debt, supported by emergency assessments against each insurer writing property and casualty business in the state, excluding workers’ compensation. The maximum annual assessment is 4 percent of premiums for payments due to hurricanes in any one year.[3] If necessary to meet its obligations for multiple-year hurricanes, an additional 2 percent assessment (plus any unused portion of the 4 percent assessment) may be imposed, so that the total assessment levied in any one year for multiple year storms may not exceed 6 percent of premium. Insurers are permitted to recoup assessments from their policyholders in

[1] Ch. 93-409, L.O.F.; s. 215.555, F.S.
[2] S. 627.0628(3)(b), F.S.
[3] S. 215.555(6)(a)3., F.S. The maximum assessment is 2 percent of gross direct written premium for the prior year, except that, if the Governor has declared a state of emergency under s. 252.36, F.S., due to the occurrence of a “covered event” (hurricane), the amount of the assessment for the contract year may be increased to an amount not exceeding 4 percent of such premium.

higher premiums.[4] The assessments are levied against authorized insurers (i.e., insurers that have a certificate of authority issued by the state) and are not levied against surplus lines insurers (insurers that are approved as "eligible" to write business in the state for risks for which coverage cannot be written by an authorized insurer).

Annual Limit on Fund Obligations (1999 changes) - The law has always limited the claims' paying obligation of the FHCF to its claims' paying capacity (i.e., all of its funds plus the maximum amount of revenue bonds that can be generated by emergency assessments). But important changes were enacted in 1999 to further limit the annual payments from the FHCF to $11 billion in any one year. The $11 billion limit is increased once the claims-paying capacity of the fund for a subsequent year reaches $11 billion (i.e., $22 billion for both years combined). At that point one-half of the excess is provided to increase the initial season capacity.[5] The Legislature recognized in 1999 that if the fund capacity was wiped out after a single season, insurers would no longer have a significant level of reinsurance from the fund, putting increasing pressures on insurers to reduce their hurricane exposure in the state by non-renewing policies, just as happened after Hurricane Andrew. By maintaining an affordable source of reinsurance for the year(s) following a major hurricane, the law helps stabilize the property insurance market.

Coverage Provided to Each Insurer - Each insurer must annually elect coverage from the fund to be reimbursed at 45 percent, 75 percent, or 90 percent of the insurer's residential hurricane losses above its retention, or "deductible." Each insurer's retention is based on its percentage share of the total retention for all insurers combined, based on its percentage of the total fund premium. The total retention for all insurers was established by law at $3 billion in 1995, and which remained the base until 1999, when the law was changed to increase the retention annually to reflect the percentage growth in exposure to the fund (due primarily to increased property value and coverage changes), which is projected to total about $4.4 billion for all insurers combined for 2003. In addition to the total $11 billion limit on reimbursement to all insurers combined, each insurer's reimbursement is limited to its percentage share of the $11 billion (or higher) limit, based on the insurer's percentage share of total premiums for fund coverage.

Current Status of the FHCF - The estimated FHCF balance for December 31, 2002 was $4.892 billion. and is expected to increase to $5.52 billion by year-end 2003, assuming no hurricane losses. These funds have been generated by insurance company premiums for FHCF coverage, which have averaged $451.6 million annually, from 1995 through 2002, plus investment income. The fund balance is lowered by the administrative expenses of the SBA in operating the fund and minimal reimbursements to insurers ($13.1 million in 1995 due to Hurricanes Erin and Opal). The balance is also lowered by legislative appropriations from the fund for hurricane loss mitigation purposes up to certain maximum amounts, described below. The fund is authorized to buy private reinsurance, but to date, the SBA has elected not to do so. If hurricane losses in 2003 require the fund to pay the $11 billion limit in annual reimbursement, the $5.52 billion fund balance would be used, plus a $5.48 billion bond issue would be required, supported by an

[4] S. 215.555(6)(a)3., F.S. This provision states that any rate filing or portion of a rate filing reflecting a rate change attributable entirely to the assessment levied shall be deemed approved when made, subject to the authority of the Department of Insurance to require actuarial justification as to the adequacy of any rate at any time.
[5] The claims paying capacity of the fund increases by the amount of each year's additional premium and investment income, but it also fluctuates due to the change in interest rates that impacts the estimate of the maximum amount of revenue that can be generated by the assessment cap.

estimated 1.78 percent assessment on property and casualty insurers, based on current interest rate assumptions. The fund is currently at a point where it estimates that its total capacity for the current and subsequent season is about $22 billion (if it levied the maximum 6 percent assessment). Therefore, the $11 billion limit for the initial season coverage will soon begin increasing under the current law. The increase would be based on increased premium and investment income, growth in the assessment base, and, possibly, lower interest rate assumptions for bonding. Alternatively, an increase in interest rates could decrease these estimates and, therefore, decrease capacity.

Mitigation Appropriations - The law directs the Legislature each fiscal year, beginning in fiscal year 1997-1998, to appropriate from the investment income of the FHCF at least $10 million, but no more than 35 percent of the investment income from the prior fiscal year for the purpose of funding local governments, state agencies, public and private educational institutions, and nonprofit organizations, to support hurricane loss mitigation programs. Actual annual legislative appropriations have ranged from the minimum $10 million to $30 million for fiscal year 2001-02. The maximum amount that may be appropriated each year for hurricane loss mitigation is 35 percent of the fund's investment income "for the prior fiscal year." A question of statutory interpretation is which year's investment income should be used to establish the 35 percent cap. It may be unclear whether the statutory reference to the investment income from the "prior fiscal year" refers to the year prior to the year for which the appropriation is made, or prior to the year during which the Legislature enacts the appropriation. If read to refer to the year prior to the year for which the appropriation is made, the Legislature must estimate the investment income for the fiscal year before it has ended. And, as 2001-02 demonstrated, it cannot be assumed that the later year will have greater investment income.

Current Problems and Proposed Solutions Identified by the SBA - The SBA has provided staff with a white paper discussion of the proposed legislation, which includes the following comments:

> *Although the 1999 FHCF legislation provided for subsequent season coverage, it did not go quite far enough in providing "full replacement" for the initial season's capacity. The population of Florida is projected to grow by about 3 million people during the next 10 years. Since 1995, the FHCF reported exposure has grown by 47%. Over one trillion dollars of insured values are now being reported to the FHCF. Currently, the growth of the FHCF capacity (coverage) is not designed to increase with the growth of insured values, but rather is highly dependent upon the level of interest rates, which tend to fluctuate. The ability to fully recharge the capacity is also limited under current law to $11 billion. There is a need for the FHCF to be structured so that capacity grows with exposure growth in the state and in such a way that there is enough subsequent season capacity to fully recharge the FHCF in order to stabilize the market following a major hurricane event that wipes out the FHCF. This will require an increase in the potential assessment authority, but such an increase is basically required to strengthen subsequent season capacity and has a low probability of being used. Under current law, the emergency assessment authority allows for up to 4% to be assessed for hurricanes in any one year, but no more than 6% to be assessed in the aggregate. The change being sought is to increase the current 4%/6% to 5%/8%. Note that this change will not increase the*

emergency assessment needed to fund an initial season total loss to the fund. Such assessment is expected to be less than 2%.

Due to the growth of cash available for funding (which is expected to exceed $5.5 billion for 2003), the emergency assessment will continue to decline as cash builds in non-triggering contract years. A hurricane event that triggers bonding is expected to occur once every twenty years. Only once every forty-five years is it expected that the maximum bonding for an initial season hurricane would be needed. As noted above the amount of this assessment is expected to be less than 2 percent. The maximum amount of bonding declines as the cash balance grows each year. The likelihood of having hurricanes exhaust the FHCF in back-to-back years is remote [a probability of about 1/2000]. *In such a scenario, the total emergency assessment percentage (assuming current interest rate levels) would be 5.5% under the current law and 5.91% under the proposed legislation. The probability of an 8% emergency assessment is .04% or 1 in 2500. There continues to be a need to establish capacity once an initial season loss occurs since the subsequent season then becomes the initial season and future capacity becomes subsequent season capacity.*

III. Effect of Proposed Changes:

The bill increases the annual limit on the amount that may be paid by the FHCF. Currently, the $11 billion limit for the initial season is increased, once the claims-paying capacity of the fund for both the initial season and subsequent seasons reaches $22 billion, which is approximately the currently estimated capacity. Instead, under the bill, the annual limit for both the initial and subsequent seasons would be set at $11 billion, but would grow annually by the same percentage as the growth in the fund’s exposure to losses (which is increased primarily due to increased property value or coverage changes). This is the same growth factor that the current law applies to each insurer’s retention or deductible. Therefore, insurers will be provided with a relatively constant layer of reinsurance, which grows by the same amount as exposure to losses grow, and which is more likely to be maintained the year following a storm season that triggers fund losses. By doing so, the property insurance market should be further stabilized, particularly after a major hurricane.

In order to fund the increased capacity described above, the bill also increases the maximum annual amount of emergency assessments against property/casualty insurers, from 4 to 5 percent for any single year’s storms, and from 6 to 8 percent for multiple-year storms. As described in more detail, above, (Current Problems and Proposed Solutions Identified by the SBA), the probability of such assessments reaching maximum levels is very small, but could be needed if multiple year storms triggered maximum levels of coverage.

The bill also adds surplus lines policies to the fund’s assessment base, thus spreading the potential cost of financing with revenue bonds over a broader base. The emergency assessments for surplus lines would operate in a similar fashion to the way the current law provides for the Citizens Property Insurance Corporation created in 2002, by which assessments are to be collected by the Florida Surplus Lines Service Office. Currently, the fund’s assessment base includes all property and casualty insurers, excluding workers’ compensation writers, and represents a gross direct written premium of about $19 billion. The addition of surplus lines adds another $1.9 billion to the assessment base. This increases the fund's overall capacity by around $1.2 billion and allows overall assessments to be reduced by about 18.5 basis points. For example, the maximum assessment percentage needed for the 2002 hurricane season was estimated at 2.05 percent, but the addition of surplus lines would have had the impact of reducing this potential assessment to 1.865 percent.

The bill specifies the year that is used to determine the investment income of the fund, for purposes of establishing the maximum amount that may be appropriated by the Legislature for hurricane loss mitigation purposes. The bill provides that it would be based on the most recent fiscal year-end audited financial statements.

The bill also increases the minimum amount of exposure (insured values) an insurer can write and be exempt from the fund. Some insurers write a minimal level of residential policies as "accommodation business" to support their commercial writings. The proposal is to change the limit from the current $500,000 to $3 million in exposure. According to the SBA, this would allow approximately 14 additional insurers the option of not participating in the fund and facilitates the administration of the fund where small premiums and very low coverage is involved. The total fund premium otherwise payable by these insurers would be less than $10,000.

The bill creates greater flexibility for the fund to purchase reinsurance by allowing the purchase of reinsurance from a reinsurer that is "acceptable" to the Office of Insurance Regulation, although such reinsurer may not have been previously approved under s. 624.610, F.S. This allows for the use of Bermuda or European reinsurers or other U.S. reinsurers, thus precluding the need for a "fronting company" arrangement and saving on costs. The SBA reports that the fund does not contemplate purchasing private reinsurance, but situations might arise in the future where it makes sense. For example, in 1999 the fund considered, but rejected, the purchase of reinsurance to protect against a shortfall in bonding.

The bill provides rulemaking authority for the SBA to exclude, by type or category, certain covered policies that require individual ratemaking methodologies for pricing the coverage if the actuarial soundness of the fund is not jeopardized. Insurers often find it extremely difficult or costly to accurately report various exposures (for the most part, commercial residential insured values) due to the unique way certain policies are written. For example, a policy may cover both commercial residential and commercial business exposures on an excess basis with blanket coverage and/or a blanket deductible on a multi-state basis. Depending on how a policy is written by the insurer, it is often impractical, or cost prohibitive for insurers to report the residential insured values for such policies. As a result, developing a proper premium and rating such a policy is a major problem, according to the SBA.

The bill also provides specific rule making authority to allow for the charging of interest on late remittances. Other technical and conforming changes are made, including adding references to the Citizens Property Insurance Corporation, where the current law refers to the former Florida Residential Property and Casualty Joint Underwriting Association and the Florida Windstorm Underwriting Association.

IV. Constitutional Issues:

A. Municipality/County Mandates Restrictions:

None.

B. Public Records/Open Meetings Issues:

None.

C. Trust Funds Restrictions:

None.

V. Economic Impact and Fiscal Note:

A. Tax/Fee Issues:

The bill increases the maximum assessments that may be levied on property and casualty insurers and also includes surplus lines policies within the assessment base.

B. Private Sector Impact:

The bill is expected to help stabilize the property insurance market, particularly after a major hurricane, by providing insurers with a relatively constant layer of reinsurance, which grows by the same amount as exposure to losses grow, and which is more likely to be maintained the year following a storm season that triggers fund losses.

Due to the fact that coverage from the fund is significantly less expensive than private reinsurance, the increased limits of fund coverage should act to lower premiums for residential property insurance policies. However, the impact is negligible at first, since the current year's coverage would not be impacted, and future increases in fund coverage is relatively modest. Therefore, the bill is not likely, in itself, to trigger rate changes, but over time would operate to lower rate increases.

Surplus lines insurance policyholders would be subject to the emergency assessments, if they are levied. See Effects of Proposed Changes, above, for the impact on increasing the assessment base.

The increase in the maximum potential assessments against property and casualty insurers has a very low probability of actually being needed (See, Present Situation, Current Problems and Proposed Solutions Identified by the SBA). But the possibility of such assessments could be realized if multiple year storms require the fund to pay maximum levels of reimbursement. In such a case, insurers would be permitted to recoup such costs by increasing premiums to their policyholders, which includes all lines of property and casualty insurance, such as motor vehicle insurance, and medical malpractice insurance, but excludes workers' compensation.

The bill increases the minimum amount of exposure (insured values) an insurer can write and be exempt from the fund. According to the SBA, this would allow approximately 14 additional insurers the option of not participating in the fund and facilitates the administration of the fund where small premiums and very low coverage is involved. The total fund premium otherwise payable by these insurers would be less than $10,000.

C. Government Sector Impact:

The bill clarifies which year's investment income is used to establish the maximum amount that may be appropriated by the Legislature from the fund for hurricane loss mitigation purposes, which would be the most recent fiscal year for which there are year-end audited financial statements.

Various other changes in the bill, as explained in more detail in Effects of Proposed Changes, are expected to reduce administrative costs of the fund.

VI. Technical Deficiencies:

None.

VII. Related Issues:

None.

VIII. Amendments:

None.