2009 - 2010 Florida Hurricane Catastrophe Fund Capacity

Background

During the 2009 Legislative Session CS/CS/CS/HB1495 was passed and ultimately signed into law by the Governor on May 27, 2009. The bill was designed to phase out the Florida Hurricane Catastrophe Fund's (FHCF) optional coverage by reducing the Temporary Increase in Coverage Limit (TICL) coverage over a six year period. The reduction in this optional coverage per year is $2 billion. Thus, the $12 billion of additional capacity which was created in the Special Session in January 2007 with the passage of CS/ HB1A, has been designed to be reduced to $10 billion for the 2009-2010 FHCF Contract Year, followed by a reduction to $8 billion the following year, etc. The TICL coverage is designed to be totally phased out by 2014. This was referred to as a "glide path" in order to transfer risk back to the private market and reduce potential assessments on Florida policyholders.

Along with the phase-out of the TICL coverage, the bill now requires that the cost of the TICL coverage be increased by a factor of 2 for 2009-2010, a factor of 3 for 2010-2011, a factor of 4 for 2011-2012, a factor of 5 for 2012-2013, and a factor of 6 for 2013-2014. The purpose of the increased cost is to allow for the transition of TICL coverage from the FHCF to the private market. The idea was to increase the cost of the TICL coverage over a period of six years to come close to matching that of the private market. In the process of phasing out the TICL coverage, large swings in residential premiums would be softened, thus residential property insurance consumers would not face large premium jumps due to the TICL coverage being shifted back to the private market. The private reinsurance market is volatile and may not be able to absorb the impact of $12 billion being shifted back in a single year.

Several other changes in HB 1495 impacted the FHCF. There was a cash build-up factor implemented that is designed to build up cash resources and offset the need to issue debt to fund hurricane losses. This factor starts off as 5% the first year, increases to 10% the second year, and ultimately reaches 25% after five years. As such, the cash build-up factor will result in a substantial increase of cash resources which will assist the FHCF in paying claims and reducing the need for future bonding. This provision was designed to address the liquidity needs of the FHCF over the long run by allowing it to accelerate the build-up of its cash balance for paying claims on a tax-exempt basis.

Another change brought about by CS/CS/CS/HB1495 was to change the FHCF Contract Year from June 1 through May 31, to January 1 through December 31, starting in 2011. Coverage for certain companies (limited apportionment companies and companies participating in the Insurance Capital Build-Up Program) was extended until 2012.

2009-2010 Coverage Selected

As a result of CS/CS/CS//HB1495, the State Board of Administration, which administers the Florida Hurricane Catastrophe Fund by the adoption of an emergency rule, allowed participating insurers to select their optional coverage up until June 30, 2009. The results are as follows:

1. Selected Coverage Percentage: 90%, 75%, or 45%
    a. There were a total of **195 companies** signing reimbursement contracts with the FHCF. This is down from 202 participating insurers last year.
    b. Of these companies, 172 companies selected 90% coverage (down 4 from last year), 23 companies selected 45% coverage (down 3 from last year), and no companies selected 75% coverage.
2. Selection of Temporary Increase in Coverage Limit (TICL Coverage) – Each company is entitled to select its FHCF premium share of a total of $10 billion of TICL optional coverage for 2009-2010.
    a. **73** companies selected TICL Coverage (down 60 from the 133 that selected TICL last year).
    b. 61 of the 73 selected their share of the full $10 billion limit available, and 12 companies selected their share at less than the full $10 billion.
    c. **122** Companies did not select TICL Coverage.
    d. The total TICL Coverage selected (based on a projection of last year's premium) was **$5,556,993,011.**
    e. Therefore, of the $10 billion available, the TICL coverage not selected was **$4,443,006,989.**
    f. The total reinsurance transferred back to the private reinsurance market, capital markets, and/or retained by insurers themselves, was **$6,443,006,989,** which includes the two billion dollar reduction in coverage by the Legislature and the above amount of TICL not selected by insurers out of the $10 billion available.
    g. Citizens Property Insurance Corporation selected in total for both accounts **$3,587,038,215** (64.55% of TICL selected):
        i. Citizens High Risk Account selected $2,359,050,233
        ii. Citizens Personal Lines Account/Commercial Lines Account selected $1,227,987,982
    h. Of the $5,556,993,011 TICL coverage selected, all other participating insurers selected **$1,969,954,796** (35.45% of TICL Selected).
    i. Excluding Citizens, the 10 companies with the highest TICL coverage selected were:
        1. Royal Palm -- $169,704,922
        2. QBE -- $139,058,889
        3. Liberty Mutual Fire -- $134,515,238
        4. Florida Peninsula -- $128,124,295
        5. Homewise -- $114,721,083
        6. Hartford -- $ 94,850,370
        7. First Protective -- $ 80,511,407

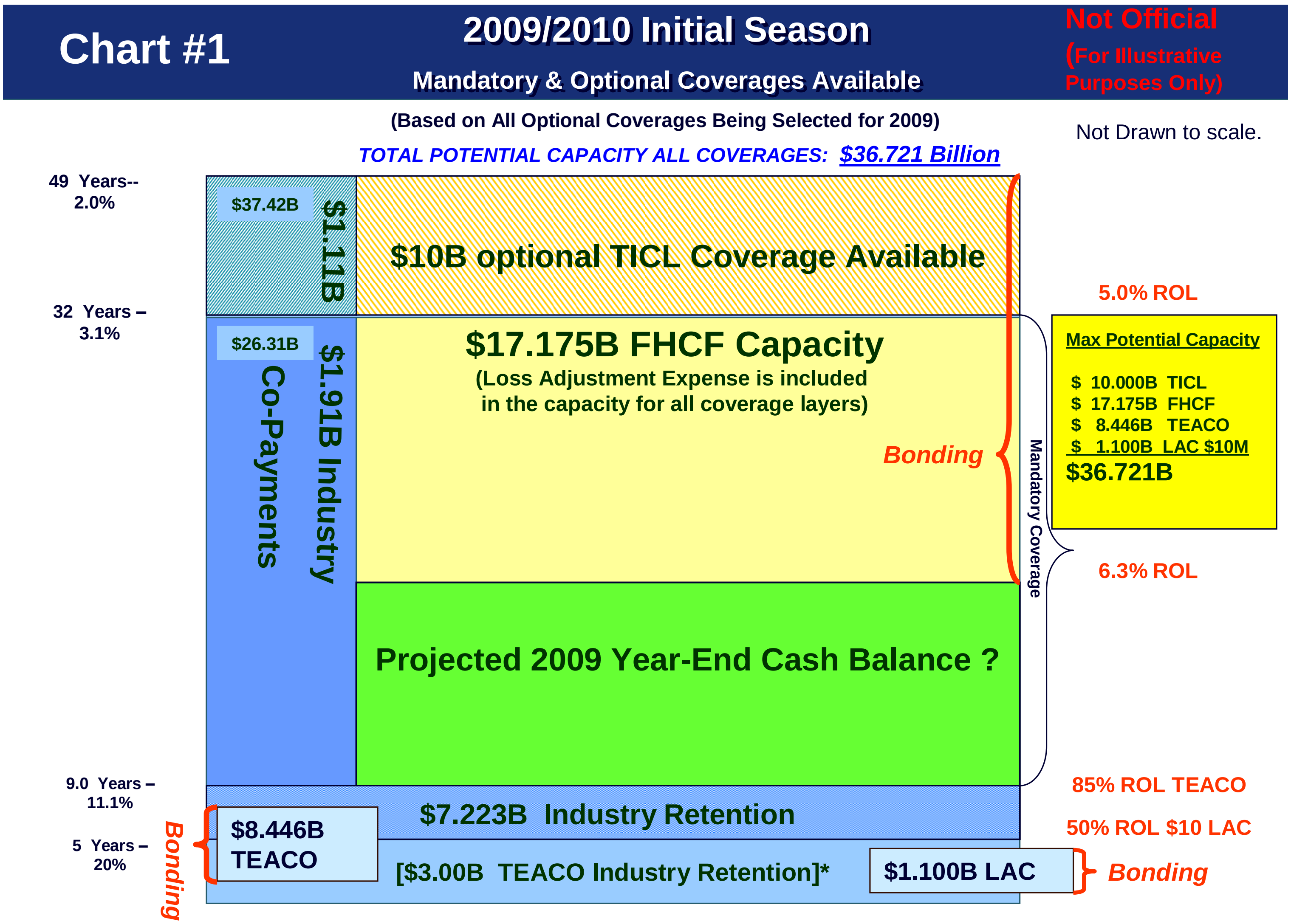
8. Magnolia -- $ 74,838,686
9. American Coastal -- $ 71,607,188
10. Security First-- $ 66,285,380

j. The following 10 other large companies chose not to select TICL Coverage:
   1. State Farm Florida
   2. Universal P&C
   3. American Home Assurance
   4. Federal
   5. USAA
   6. American Security
   7. USAA Casualty
   8. Allstate Floridian
   9. ASI Assurance
   10. Universal Insurance Company of North America

3. Participating Insurers Selecting the Up to $10 Million Coverage Option (LAC)
   a. **25** companies selected the coverage, out of a total of 55 companies that were potentially eligible to select the coverage.
   b. 21 companies selected the full $10 million, whereas 4 companies selected less than $10 million in coverage.

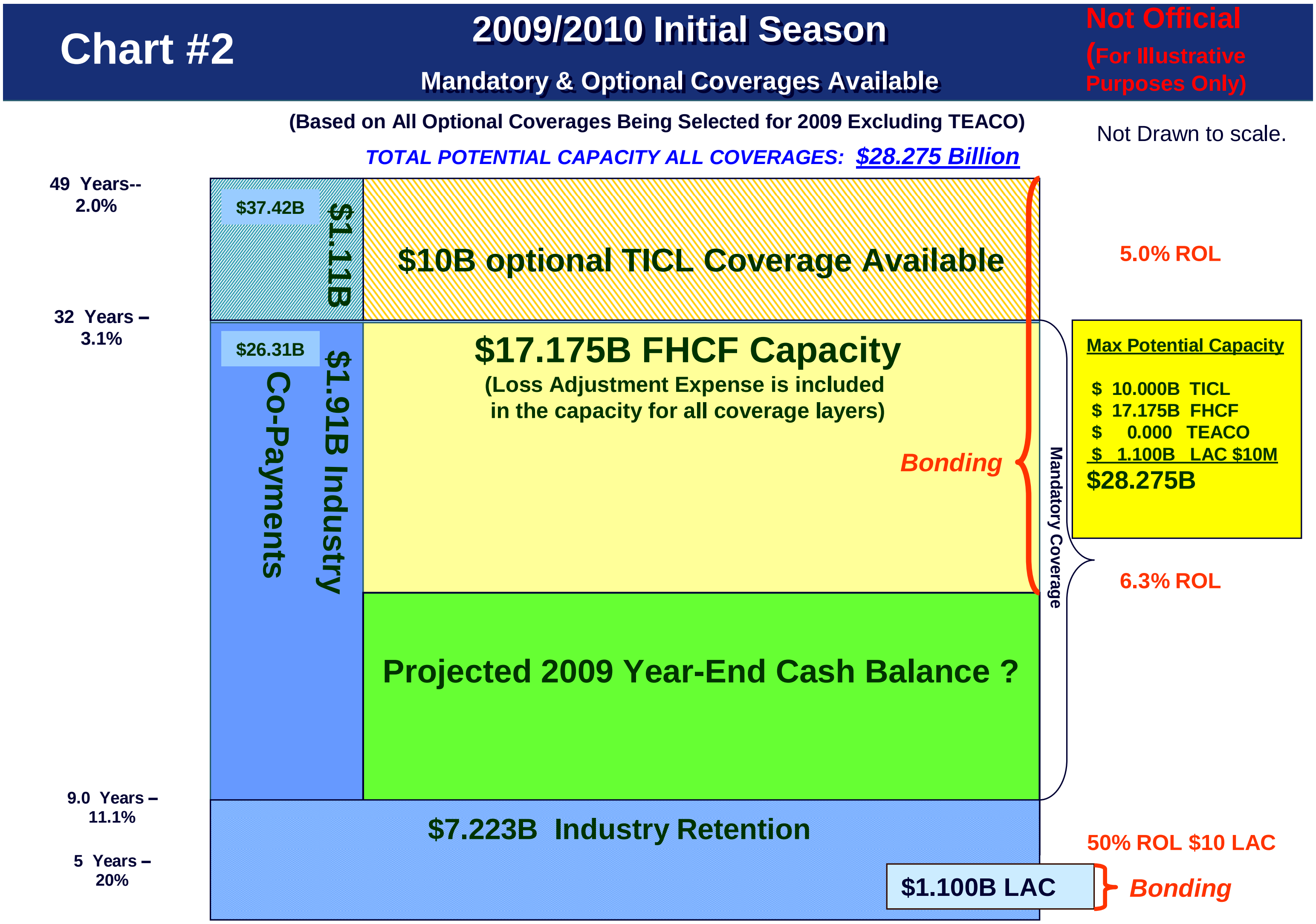
Structure of the FHCF Coverage 2009-2010

Given the coverage available from the FHCF for 2009-2010, the total capacity could have been as high as **$36.721 billion (this is a theoretical number)**. But this includes approximately $8.446 billion that could have potentially been purchased for the Temporary Emergency Additional Coverage Option (TEACO coverage). Due to its high price relative to the private market and high potential for triggering FHCF recoveries, the TEACO coverage was priced high to make coverage available in a market crisis, but to encourage the purchase in the private market if such coverage was needed by insurers and available from the private reinsurance markets. Over the last three years, no insurer has selected TEACO coverage. The following chart illustrates this capacity. Prior to coverage being selected, the projected 2009 Year-end Cash Balance is shown as unknown.



*Individual company retentions are their share of the industry retention.

Excluding TEACO coverage, the potential capacity from the FHCF would have been **$28.275 billion**. This number assumes that all participating insurers selected the maximum Temporary Increase in Coverage Limit (TICL coverage) and those eligible selected their full share of the "up to $10 million" of optional coverage below the FHCF's industry retention. The following chart illustrates the potential capacity, excluding TEACO. Again, prior to coverage being selected, the projected 2009 Year-end Cash Balance is unknown.

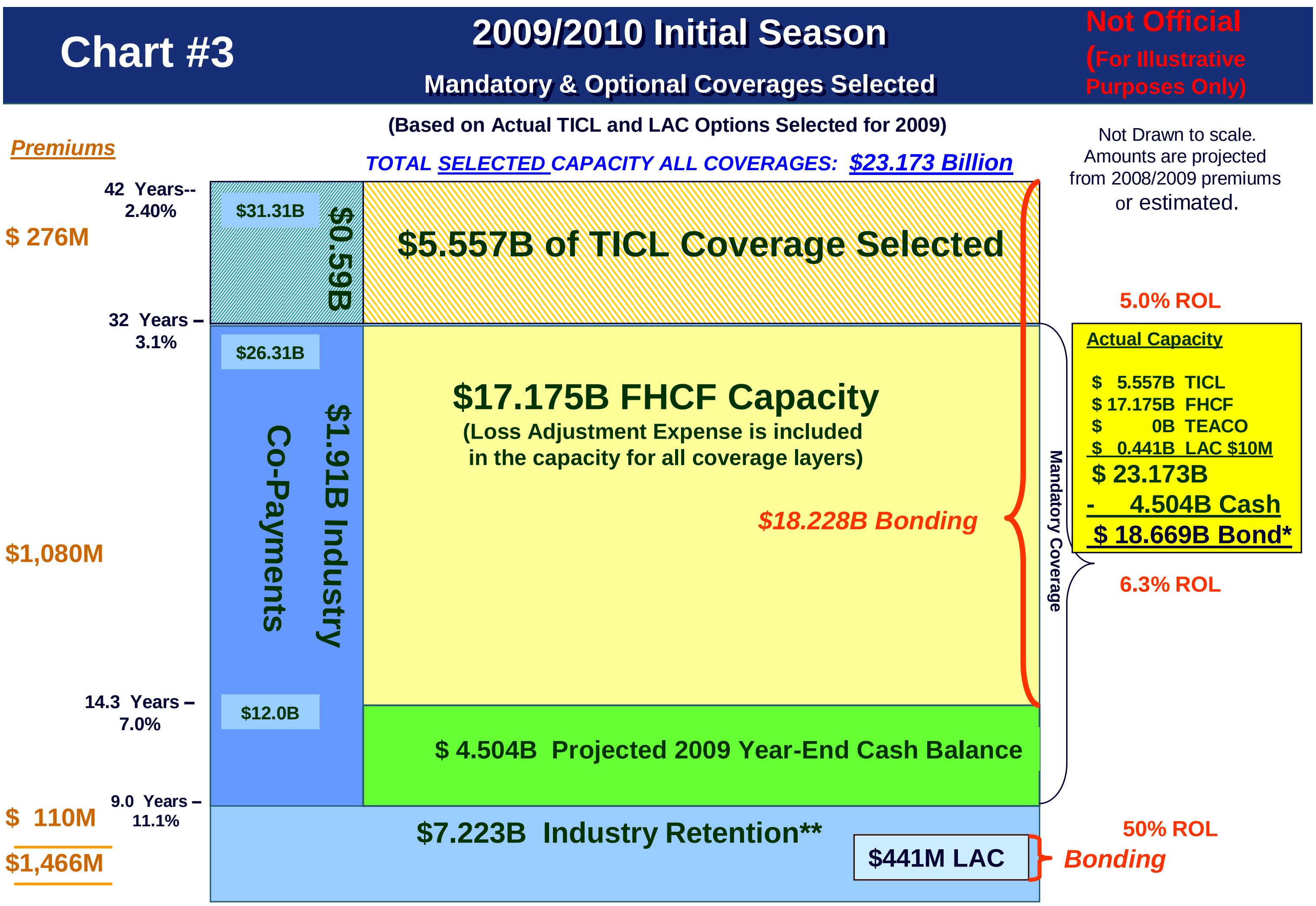


Actual FHCF Coverage Selected for 2009-2010

Based on the actual coverages selected ("TICL," "TEACO," and the "up to $10 million option"), the FHCF's maximum potential capacity for 2009-2010 is reduced to **$23.173** billion. This is made up of $17.175 billion of potential mandatory coverage, $5.557 billion of TICL coverage selected, and $441 million for the up to $10 million option. TEACO was not selected.

Each insurer will absorb its share of the industry retention of $7.223 billion prior to the FHCF reimbursing losses. Although, companies that choose the up to $10 million optional coverage, will trigger at 30% of their surplus. In addition, each insurer will absorb about 10% of the losses above their retention (deductible). The FHCF will pay

5% for loss adjustment expenses for recovery in addition to the reported losses up to each insurer's limit of FHCF coverage available. From the chart below, it can be seen that the maximum potential for bonding or debt issuance to fund the FHCF's capacity is $18.669 billion. This is the difference in the overall limit of potential capacity, less the available projected cash balance of $4.504 billion. The second chart below represents the pre-event bonding resources which will assist the FHCF's liquidity position. Eventually, the FHCF may be required to replace the pre-event debt with permanent financing, especially in a large event scenario. Total potential capacity is $23.173 billion ($5.557 billion for TICL coverage, $17.175 billion for the mandatory coverage, and $441 million for the up to $10 million option for certain eligible insurers). Since the selected coverage is known, the projected premiums can be used to calculate the projected 2009 Year-End Cash Balance available for paying claims. This number is $4.504 billion. The chart below illustrates this:

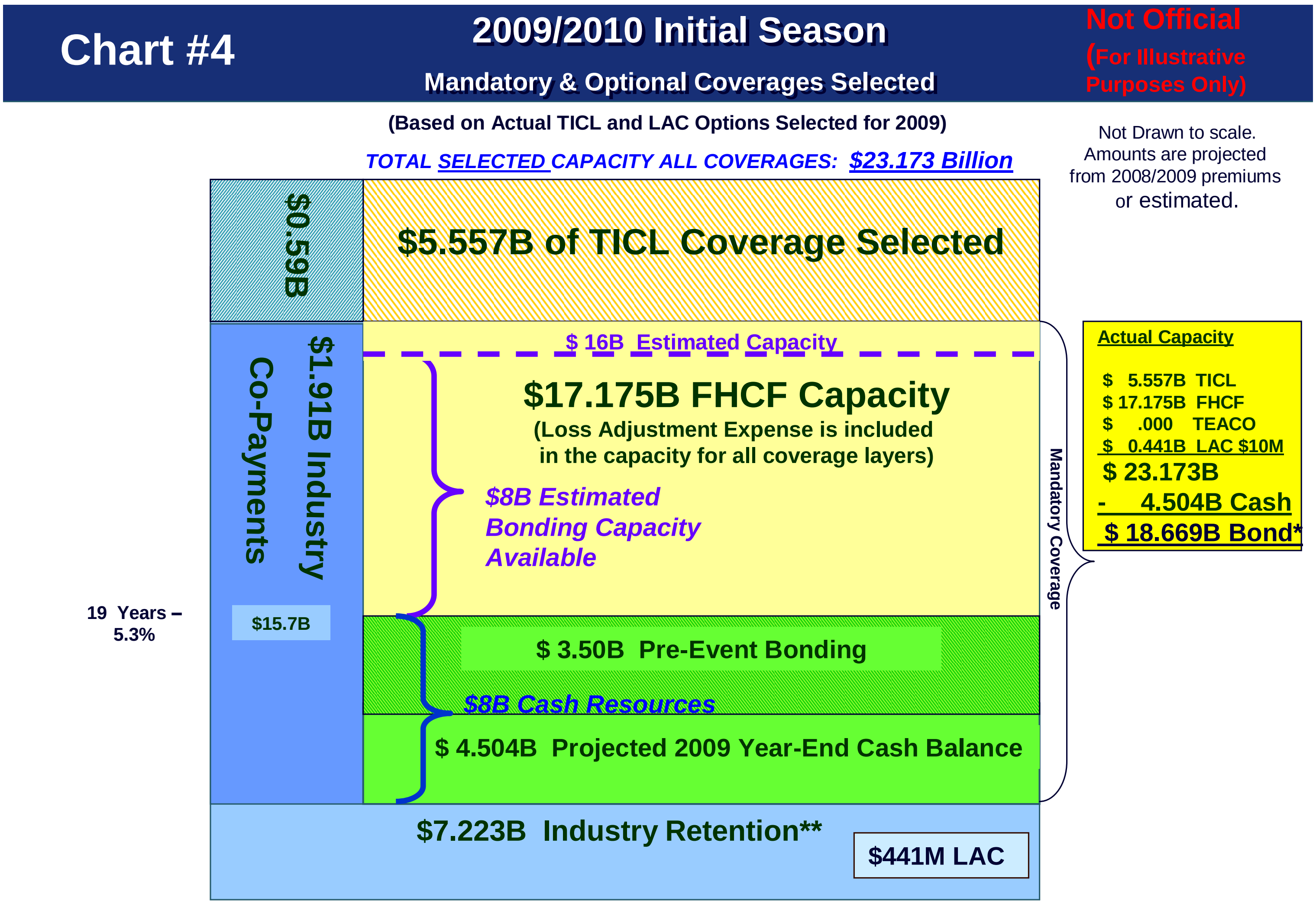


* This number includes the $18.228B plus the $441M needed to fund the LAC Coverage.
**Individual company retentions are their share of the industry retention.

Estimated 2009-2010 FHCF Capacity and Resources

In May 2009, the FHCF estimated its loss reimbursement capacity at **$15.960 billion**. See page 5 of the report found at the following link on the FHCF's website: http://www.sbafla.com/FHCF/LinkClick.aspx?fileticket=D3FM7QiFVt0%3d&tabid=473&mid=1416.

The $15.960 billion is rounded to $16 billion for the purpose of the chart below. But, what is illustrated is that the $16 billion of capacity is made up of roughly $8 billion in liquid cash resources ($4.504 billion from the projected 2009 Year-end Cash Balance and $3.5 billion in Pre-Event Bonding) and $8 billion in estimated bonding capacity. The chart below illustrates these numbers, and a dotted line is drawn representing the estimated capacity of $16 billion which falls below the mandatory coverage maximum limit of $17.175 billion. It is also noted that the TICL coverage of $5.557 billion may not be funded based on the estimated capacity number of $16 billion. The up to $10 million optional coverage limit is represented as a capacity of $441 million and is labeled $441M LAC in the chart. By law, this coverage would be paid concurrent with the mandatory coverage, but would limit those companies selecting the coverage to their share of the total capacity available in situations involving industry losses that exceed $16 billion. The chart below also illustrates that it would take an industry loss exceeding $15.71 billion to exhaust currently available cash resources. The probability of this happening is around 5.3%.



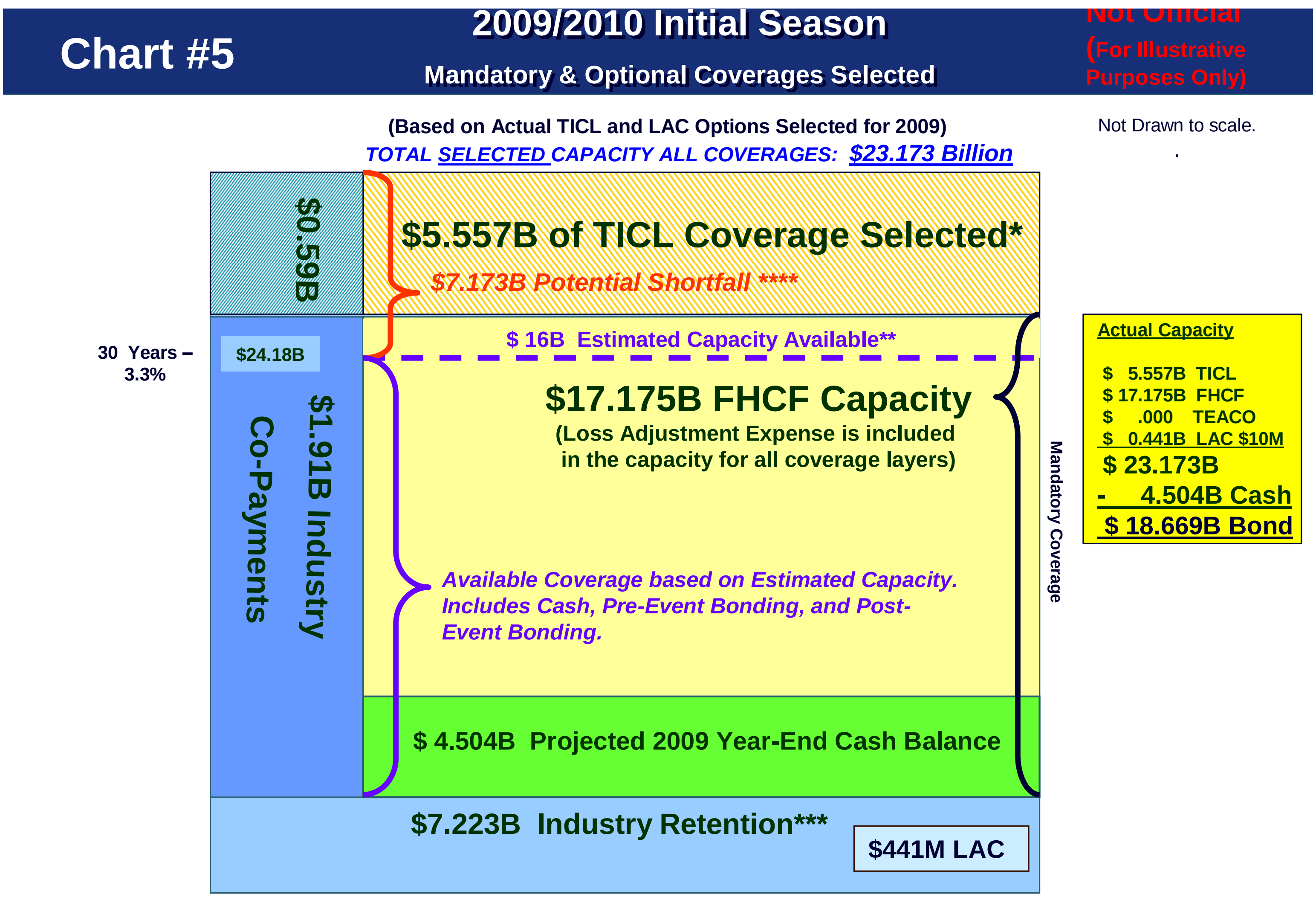
* This number includes the $18.228B plus the $441M needed to fund the LAC Coverage.
**Individual company retentions are their share of the industry retention.

Potential FHCF Shortfall for 2009-2010

By law, the obligation of the State Board of Administration related to the FHCF is limited to the available cash balance and the amount that it can raise by the issuance of revenue bonds. This has always been the case since the inception of the FHCF. However, beginning in 1999, a limit of annual liability was included, thus preserving capacity for subsequent seasons when actual claims-paying capacity exceeded the statutory adjusted limit. The limit for the mandatory coverage is designed to adjust each year and under current law is set at $15 billion in Section 215.555(4)(c)1., Florida Statutes as of 2003, to be adjusted annually. The language reads as follows:

(c)1. The contract shall also provide that the obligation of the board with respect to all contracts covering a particular contract year shall not exceed the actual claims-paying capacity of the fund up to a limit of $15 billion for that contract year adjusted based upon the reported exposure from the prior contract year to reflect the percentage growth in exposure to the fund for covered policies since 2003, provided the dollar growth in the limit may not increase in any year by an amount greater than the dollar growth of the balance of the fund as of December 31, less any premiums or interest attributable to optional coverage, as defined by rule which occurred over the prior calendar year.

A potential shortfall relates to the difference in estimated claims-paying capacity versus the maximum theoretical capacity available. The FHCF is required, by law, to estimate its capacity twice a year (in May and October) in order to provide participating insurers with a realistic estimate of the FHCF's capabilities. For the upcoming 2009-2010 FHCF Contract Year, this potential shortfall is illustrated below in the following chart as **$7.173 billion.**



* Amounts are projected from 2008/2009 premiums.
** This number is based on the May 2009 Estimated Loss Reimbursement Capacity.
***Individual company retentions are their share of the industry retention.
****The potential shortfall is from the maximum theoretical capacity which includes the $441 LAC coverage amounts.

The dotted line illustrates the estimated claims-paying capacity as of May 2009. It should be noted that the financial markets change daily and the amount of debt that can be issued following a hurricane event that exhausts the liquid resources of the FHCF may be drastically different from the estimates. The estimated claims-paying capacity numbers are "good faith" estimates, but do have their limitations. It can also be noted in the above chart that an event large enough to exhaust the estimated claims-paying capacity is expected to occur only once every 30 years and has a probability of occurrence of 3.3%.

CONCLUSIONS

The enactment of CS/CS/CS/HB1495 has resulted in a transfer back to the private market of as much as $6,443,006,989 in residential property insurance losses should a large event occur. The law phases out the entire $12 billion TICL coverage created in January 2007, as a result of HB1A, over a six year period. Additionally, the legislation has allowed for the greater build-up of cash resources in the FHCF by requiring for the charging of a higher cost for TICL coverage and for a cash build-up charge in the mandatory coverage. Based on the financial markets and recent estimates of the FHCF's claims-paying capacity, participating insurers have limited their selection of optional coverages. Only $5.557 billion of TICL coverage was selected out of a total maximum of $10 billion available under the law. Of the coverage selected, Citizens Property Insurance Corporation selected roughly $3.6 billion of TICL coverage and all other participating residential insurers selected slightly less than $2 billion in TICL coverage. Only 37% of insurers (73 of 195) selected TICL coverage. For the "up to $10 million of optional coverage" available to certain specified insurers, only $441 million of coverage was selected by 25 insurers out of a potential of 55 insurers that were eligible for coverage.

The FHCF's current estimated capacity for the 2009-2010 Contract Year is $16 billion (based on the May 2009 claims paying capacity estimates). This is expected to be funded with $8 billion of currently available liquid resources (cash of $4.5 billion and $3.5 billion of pre-event notes) and $8 billion of estimated post-event bonding. The potential shortfall from the "theoretical maximum" that could be offered under law is $7.173 billion. Although still a significant number, this number is much below the $18.5 billion potential shortfall from maximum potential coverage reported earlier in the year. Chart #6 below illustrates the reduction in the potential shortfall from reported numbers earlier in the year. Over time, given the provisions in CS/CS/CS/HB1495, the potential limit of liability will be reduced substantially and the cash balance will have the opportunity to build in order to prepare the state for the next big hurricane or series of hurricanes that devastate residential property in the state.

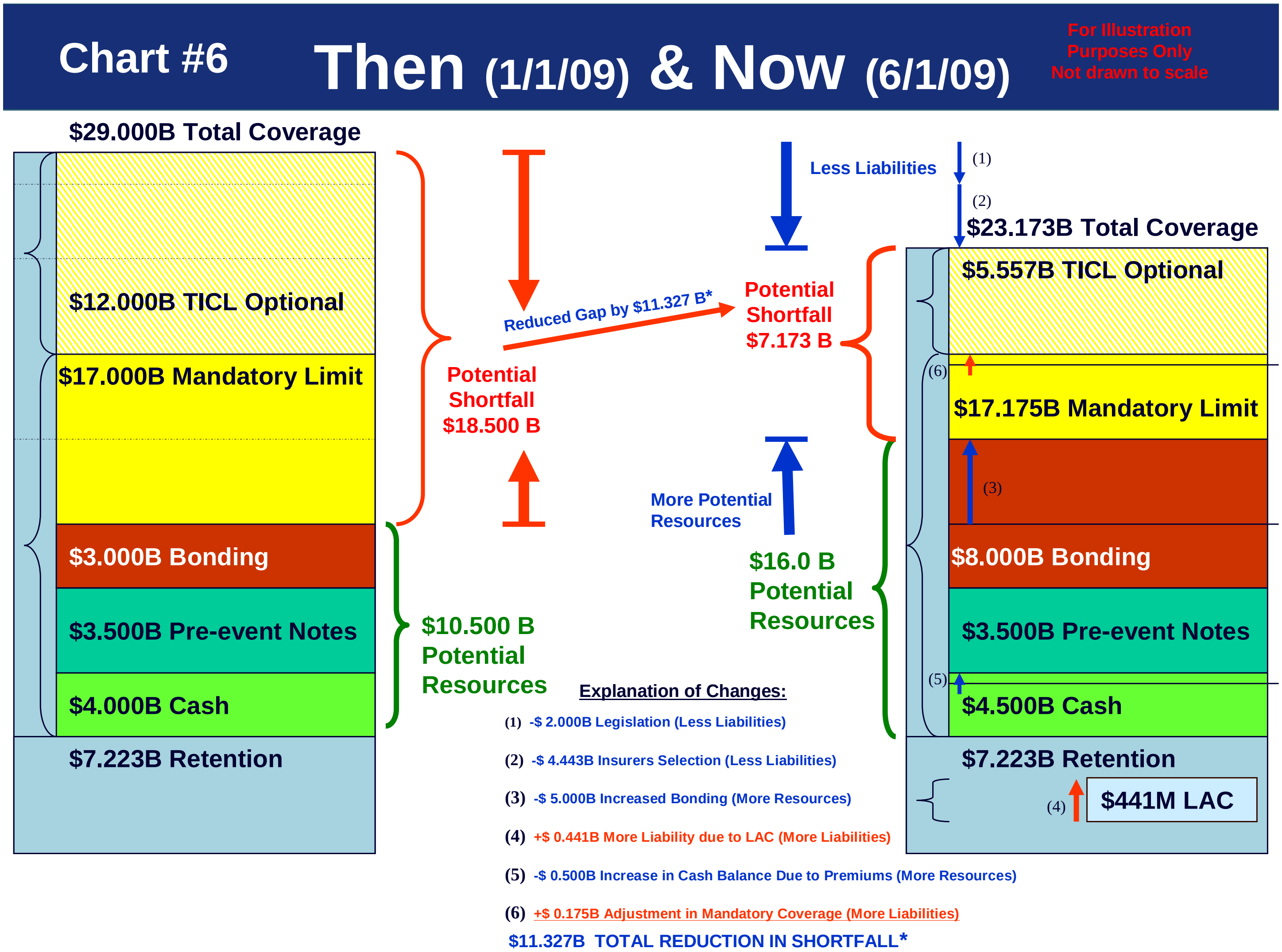


Chart #6
Then (1/1/09) & Now (6/1/09)
For Illustration Purposes Only
Not drawn to scale
$29.000B Total Coverage
$12.000B TICL Optional
$17.000B Mandatory Limit
$3.000B Bonding
$3.500B Pre-event Notes
$4.000B Cash
$7.223B Retention
Potential Shortfall $18.500 B
$10.500 B Potential Resources
Reduced Gap by $11.327 B*
Less Liabilities
More Potential Resources
Potential Shortfall $7.173 B
$16.0 B Potential Resources
(1)
(2)
$23.173B Total Coverage
$5.557B TICL Optional
(6)
$17.175B Mandatory Limit
(3)
$8.000B Bonding
$3.500B Pre-event Notes
(5)
$4.500B Cash
$7.223B Retention
(4)
$441M LAC
Explanation of Changes:
(1) -$ 2.000B Legislation (Less Liabilities)
(2) -$ 4.443B Insurers Selection (Less Liabilities)
(3) -$ 5.000B Increased Bonding (More Resources)
(4) +$ 0.441B More Liability due to LAC (More Liabilities)
(5) -$ 0.500B Increase in Cash Balance Due to Premiums (More Resources)
(6) +$ 0.175B Adjustment in Mandatory Coverage (More Liabilities)
$11.327B TOTAL REDUCTION IN SHORTFALL*

8/26/09