Florida Property Insurance 101

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Overview

- How does property/casualty insurance work, and how well does it work in dealing with natural disasters?
- Florida's hurricane problem
- The state role
- Where do we go from here?

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Definition

- Insurance is the system that enables us:
  - To transfer the cost of life's tragedies from ourselves to others...
  - By paying in advance...
  - Based on the relative likelihood of loss
- Risk transfer, not risk sharing
- Insurance is all about low-probability events

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Predictability

- In order to be economically viable, the system requires predictability
- Example: fire insurance
  - Very little year-to-year variation in fire costs
  - So if there's a 0.1% chance any given home will burn down this year, I can collect $200 or so from each of 1,000 $200K homes and have enough to cover the risk, but what if 2 homes burn down?
  - It works better if I collect $200 or so from each of 10,000 homes, in case 11 burn down instead of 10, and so on
  - Bottom line: because there's so little variability, your premium is almost entirely a reflection of the probability of your home burning down this year

Risk-based pricing

- Risk-based pricing enables an insurer to offer the lowest possible price to the consumers who are the best risks and creates incentives for everyone else to behave more safely
- Example: auto insurance
  - If I charged everyone the same price for auto insurance:
    - Someone would come along with lower premiums for the best drivers
    - I'd end up covering too many high-risk drivers and not enough low-risk drivers
    - I'd soon be out of business
  - All drivers know that unsafe behavior results in higher insurance premiums, so everyone's incentivized towards driving more safely

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Insurance economics of catastrophes

- Insurance against natural disasters doesn't fit neatly into this model
  - In fire and auto, there's not a lot of difference between an average year and an outlier year
  - With catastrophes, there's no such thing as an average year. Some years produce huge losses, well in excess of premiums, but other years produce few claims and huge profits

Insurance economics of catastrophes

- The volatility of catastrophes means that insurers must engage in risk-transfer, too
  - They buy reinsurance or engage in other transactions to transfer some of their risk of loss to others
  - Insurers generally need to be able to cover at least the 100-year worst case (known as "Probable Maximum Loss")
  - This risk transfer is needed because no insurer can raise enough premium revenue to cover anything close to a 100-year worst case
  - But it comes at a price

Insurance economics of catastrophes

- The price of volatility
  - The year-to-year volatility of hurricane losses means that the cost of insuring against hurricanes is higher than the cost of insuring against more predictable—but equally probable—events
  - In other words, if there's a 0.1% chance your house will burn down this year, and a 0.1% chance your house will blow down, fire protection will cost less than wind protection...
  - ...because fire losses can be covered from this year's premiums without outside help, and hurricane losses can't

Insurance economics of catastrophes

- The price of volatility, continued
  - Where there's not a whole lot of difference between an average year and an extreme year, the cost of insurance is close to the average loss, but where there's a lot of difference, the cost of insurance will be much higher

Florida's vulnerability—the national perspective

- Florida is responsible for 49.5% of the nation's average annual insured hurricane loss...$1.4 billion
  - Texas is next, with $615 million, followed by Louisiana, with $196 million
- Florida leads the nation in the insured value of coastal residential property, with $942.5 billion
  - New York is next, with $512 billion, followed by Massachusetts, with $306 billion

Florida's vulnerability— science and history

- Scientific consensus:
  - Atlantic and Gulf hurricanes run in cycles of roughly 30 years
  - The current, active cycle began about 10 years ago
- Frequent major hurricanes are not uncommon in our history:
  - 1919-1935: one Category 5, three Category 4, three Category 3
  - 1944-1950: one Category 4, seven Category 3
- 40.5% of all hurricanes to hit the U.S. (38.5% of all Cat 3, 4, or 5) made landfall in Florida
  - All of Florida's Cat 4 or 5 storms, and 2/3 of Florida's Cat 3 storms, made landfall south of I-4

Florida's vulnerability—hurricane costs

- 6 of the 10 costliest hurricanes in U.S. history were Florida hurricanes
  - Andrew (1992), Wilma (2005), and the four 2004 storms
- Reruns of historic hurricanes would cause huge losses, given today's housing patterns and property values
  - The 1926 Miami Beach hurricane would cause losses of $130 or more billion today
  - Andrew would cause losses of $50 billion
  - The Lake Okeechobee hurricane (1928) would cause losses of $30 billion

Florida's vulnerability—what a "minor" hurricane can do

- Hurricane Wilma
  - Category 2 hurricane
  - Sustained wind speeds never exceeded 100 mph over land in Florida
  - Insured losses to residential property reached $10 billion

Eight hurricanes in 2 years: 2004 and 2005 losses

- Costs:
  - 2004: Over $20 billion in residential insurance claims (affecting about ¼ of all Florida homeowners)
  - 2005: Over $10 billion in residential insurance claims
- Revenues:
  - Annual premiums collected for homeowners insurance in the private sector: $5.5 billion (2005)
  - Annual premiums collected by Citizens (2005): $1.5 billion
  - Note that these premiums are not just for hurricane damage, but must also cover more traditional perils, such as fire, theft, and liability

Regulation

- The state regulates every aspect of the insurance business...policy provisions, marketing and claims practices, solvency, rates
- Regulation is more intensive than any other private sector industry
- In practice, a shifting balance between availability and affordability

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Rate regulation

- Rates must be approved by the Office of Insurance Regulation (OIR)
- All of the presumptions run in OIR's favor
- Statutory standard: rates may not be
  - Excessive
  - Inadequate
  - Unfairly discriminatory
- Ratemaking is prospective…that is, next year's premiums pay for next year's losses, not this year's losses

Rate regulation: "Excessive"

- Statutory standard:
  - "Rates shall be deemed excessive if they are likely to produce a profit from Florida business that is unreasonably high in relation to the risk involved in the class of business or if expenses are unreasonably high in relation to services rendered."
- But what does "the risk involved" mean in the context of hurricanes?
- Is "unreasonably high" a political concept or an actuarial concept?

Rate regulation: "Inadequate"

- Statutory standard:
  - "Rates shall be deemed inadequate if they are clearly insufficient, together with the investment income attributable to them, to sustain projected losses and expenses in the class of business to which they apply."
- But what does "projected losses" mean in the context of hurricanes?
- Rate adequacy is all about preventing insolvencies

Rate regulation: "Unfairly discriminatory"

- "Unfairly discriminatory" is an insurance concept, not a civil rights concept
- Statutory standard:
  - "A rate shall be deemed unfairly discriminatory as to a risk or group of risks if the application of premium discounts, credits, or surcharges among such risks does not bear a reasonable relationship to the expected loss and expense experience among the various risks."
- In other words, the premium as to a particular policyholder must reflect that policyholder's likelihood of incurring a loss
- This is what keeps low-risk areas from subsidizing high-risk areas

Rate regulation: Hurricane loss modeling

- Rate regulation is about comparing proposed prices to "expected losses." How can "expected losses" be determined in the context of extreme but infrequent events?
- Need for objective standards for determining adequacy of rates, but...
- Simple reliance on historical losses does not work
  - Not enough data
  - Massive changes in population patterns and property values
- Computer models simulate thousands of years of weather as applied to defined sets of exposures
- Originally developed for use by reinsurers in pricing the product they sold to insurers
- Regulators were—and many still are—reluctant to allow use of models because of the concern that models are insurer-controlled "black boxes"

Rate regulation: Hurricane loss modeling

- In 1995, Florida legislators responded to the regulator's refusal to allow insurers to use models by creating a public commission to evaluate models
  - Experts from a variety of fields appointed to set standards for models
  - Private sector modelers submit their models to the commission for annual evaluation
- Originally, the results of commission-approved models were presumed valid; one year later, the legislature reduced the status of model results to "admissible and relevant"
- The legislature has also funded a public hurricane loss model
  - OIR began using the public model in 2006 in reviewing rate filings
  - The public model received Modeling Commission approval in 2007

State created insurance programs

- Cat Fund and Citizens
  - Both entities depend on premiums now and taxes (“assessments”) later
  - Both shift costs from the present to the future
  - To an extent, both shift costs from high-risk areas to the state as a whole
- Florida Insurance Guaranty Association
  - Pays claims of insurers that have become insolvent
  - Also relies on assessments for its funding

Florida Hurricane Catastrophe Fund (The Cat Fund)

- Created in 1993, in response to the post-Andrew contraction in the supply of catastrophic reinsurance
- Original purpose was to create a stable source of reinsurance at a stable price
- Coverage expanded in 2007 as a way to support property insurance rate rollbacks
- Governed by the State Board of Administration (Governor, CFO, and Attorney General)
- Exempt from federal taxation and able to issue tax-free bonds

Florida Hurricane Catastrophe Fund (The Cat Fund)

- What the Cat Fund does
  - Provides a layer of reinsurance that, in the aggregate, kicks in at a statewide insured residential hurricane loss of $6.1 billion
  - The cost of Cat Fund coverage is much lower than the cost of comparable coverage from private reinsurers
  - Provides most insurers with 90% of their hurricane losses above that level, up to a cap
  - For 2007, the fund provided $28 billion in coverage ($16 billion, plus a new $12 billion layer)
    - It would have maxed out at a statewide insured residential loss of $37 billion

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Florida Hurricane Catastrophe Fund (The Cat Fund)

- How the Cat Fund is supported
  - Premiums—insurers pay risk-based premiums for their coverage
  - Bonds—when the fund doesn't have enough cash to meet its obligations, it can borrow money
  - Assessments—to pay off the bonds, the Cat Fund can levy assessments on all property/casualty insurance premiums (not just property) except for workers' comp and med mal; maximum assessment is 10% a year

Citizens Property Insurance Corp.

- State-created insurer operating under a state-appointed board
- Provides full-coverage residential policies and windstorm-only policies
- Originally an insurer of last resort, now allowed to compete with the private sector
- Rates rolled back to their 2006 levels through year-end 2008
- About 1.3 million policies in force
- Funded through premiums and assessments
  - Assessment structure similar to the Cat Fund, except that there are no hard caps on Citizens assessments

HB 1-A rate rollbacks

- HB 1-A (January 2007) did many things, including substantial changes to Citizens, but most of the public attention has focused on the rate rollbacks
- HB 1-A required immediate rate filings to reflect the impact of the expansion of the Cat Fund
- "Presumed factor" filings reflected the 24% reduction calculated by OIR, to be followed with "true-up" filings to reflect the actual impact on the insurer
- Controversy: was the presumed factor realistic, or were the rate reductions oversold?

HB 1-A rate rollbacks

- Oversold or realistic?
  - Insurers' base rates didn't necessarily reflect the full cost of reinsurance in 2006, which was a record-high year (but the presumed factor apparently assumed that they did)
  - Policymakers may have overestimated the impact of the extra $12 billion layer of Cat Fund coverage, which is available at about the 35-year loss level and taps out at about the 60-year loss
  - Many consumers haven't seen their new rates yet, or their 2007 renewals include both OIR-approved increases from 2006 and the rollbacks

What's next?

- More regulation?
- Further expansion of the Florida Cat Fund?
- Creation of a federal Cat Fund? Multi-state funds?

Contact information

- For further information, please contact

Leonard Schulte

Foley & Lardner LLP

106 E. College Ave.

Suite 900

Tallahassee, FL 32301

lschulte@foley.com

850.513.3380

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