Consumer Federation of America

July 28, 2020

Honorable Toni Atkins, President pro Tempore
Honorable Anthony Rendon, Speaker
Honorable Susan Rubio, Chair, Senate Insurance Committee
Honorable Brian Jones, Vice-Chair, Senate Insurance Committee
State Capitol
Sacramento, CA. 95814
Sent via email

Re: Actuarial opinion concerning AB 2167 (Daly) and its impact on California homeowners insurance premiums

Dear President pro Tempore Atkins, Speaker Rendon, and Senators:

I am providing this letter to reflect my significant concern, as an actuary and consumer advocate, for the millions of California homeowners, renters, condominium owners, and mobile homeowners who will face steep premium increases if AB 2167 (Daly) and a companion bill SB 292 (Rubio) are adopted. I note that my particular focus is on the impact of allowing insurers to pass through the cost of reinsurance to Californians as the legislative package would allow. There are other deregulatory aspects of the legislative package that would further weaken the state's consumer protections, but I have narrowed my analysis here because of the outsize impact of the proposed reinsurance pass-through. With more than 60 years of actuarial experience in government and the private sector, I have no doubt that this provision of AB 2167 will drive up the average cost of insurance in California by hundreds of dollars per home and subject the state's homeowners insurance market to additional spikes in price and non-renewals as it becomes tethered to unregulated and erratic global reinsurance markets.

**Qualifications**

I am an actuary, a Fellow in the Casualty Actuarial Society (by examination) and a Member of the American Academy of Actuaries. Formerly, I served as Federal Insurance Administrator under Presidents Ford and Carter and as Texas Insurance Commissioner. Presently I am the Director of Insurance for the Consumer Federation of America. Additionally, I authored "Insurance in California: A 1986 Status Report for the Assembly." That study, commissioned by the California State Assembly, addressed both "Profitability, Competition, and Equity in Selling and Pricing of Private Passenger Automobile Insurance" and "The Crisis in Day Care and Municipal Liability Insurance."

I am particularly experienced in disaster-prone ratemaking and insurance practices, including reinsurance for such risks. As Chief Actuary for the Federal Insurance Administration, I developed rates and insurance practices for the National Flood Insurance Program and the Riot Reinsurance Program. Later, as Administrator, I ran both Programs. In the Riot Reinsurance Program, I calculated the reinsurance rates that we charged the primary insurance companies to cover that peril. I also served as a consulting actuary to the California Earthquake Authority, however, I resigned from that assignment after about two years when it became evident that the Authority would not heed my advice to reduce its reliance on earthquake reinsurance from private reinsurers whose charges, I believed, were excessive. I do note that CEA has since moved in that direction.

I also was deeply involved in Florida's efforts to stabilize its insurance and reinsurance markets in the wake of Hurricane Andrew (1992) and the series of hurricanes of 2004 and 2005. After these storms, insurance companies imposed enormous increases on property insurance policies and many threatened to withdraw from the market altogether. In both cases, I was involved in analyzing rates, developing the solutions, and implementing them, including in my role as a consultant to the Florida Office of Insurance Regulation (Florida's name for its Insurance Department). I will discuss the events following the catastrophic 2004-05 hurricanes in some detail below.

**Current Situation for Home Insurance in California**

Right now, because of the strong consumer protections these bills aim to overturn, Californians pay less for home insurance coverage than residents of most other states, and significantly less than other catastrophe prone large states that allow the pass though of reinsurance, such as Florida and Texas, as well as Colorado, which has the third highest wildfire exposure behind California and Texas,[1] as shown in the table below.

| State | Average Premium for $200,000- $299,999 Home | Average Premium for all Homes |
|---|---|---|
| California | $695 | $1,008 |
| Texas | $1,776 | $1,951 |
| Florida | $1,794 | $1,893 |
| Colorado | $1,306 | $ 1,495 |
| Countrywide | $1,092 | $1,211 |

Source: National Association of Insurance Commissioners (2019). Dwelling Fire, Homeowners Owner-Occupied, and Homeowners Tenant and Condominium/Cooperative Unit Owner's Insurance Report: Data for 2017

Astonishingly, the average premium for homeowners insurance in California is 17% less than the national average, even though the average insured value of the homes in the state is 33% higher than the national average.[2]

This substantially lower-than-average premium for Californians is great news for the state as a whole, but I also recognize that many Californians in wildfire-prone parts of the state are facing severe price hikes now, which need to be addressed. However, this bill would simply allow even higher premiums in high-risk areas and extend high rates beyond these communities to millions of residents statewide. Put differently, the legislation would increase profits for insurers without protecting homes from wildfire losses, because the bill does not address the real issue: exposure to wildfire risk. In that regard, California homeowners would be well-served by loss prevention investments and assurances that mitigation will yield the premium relief that should come with risk reduction. But allowing insurers to

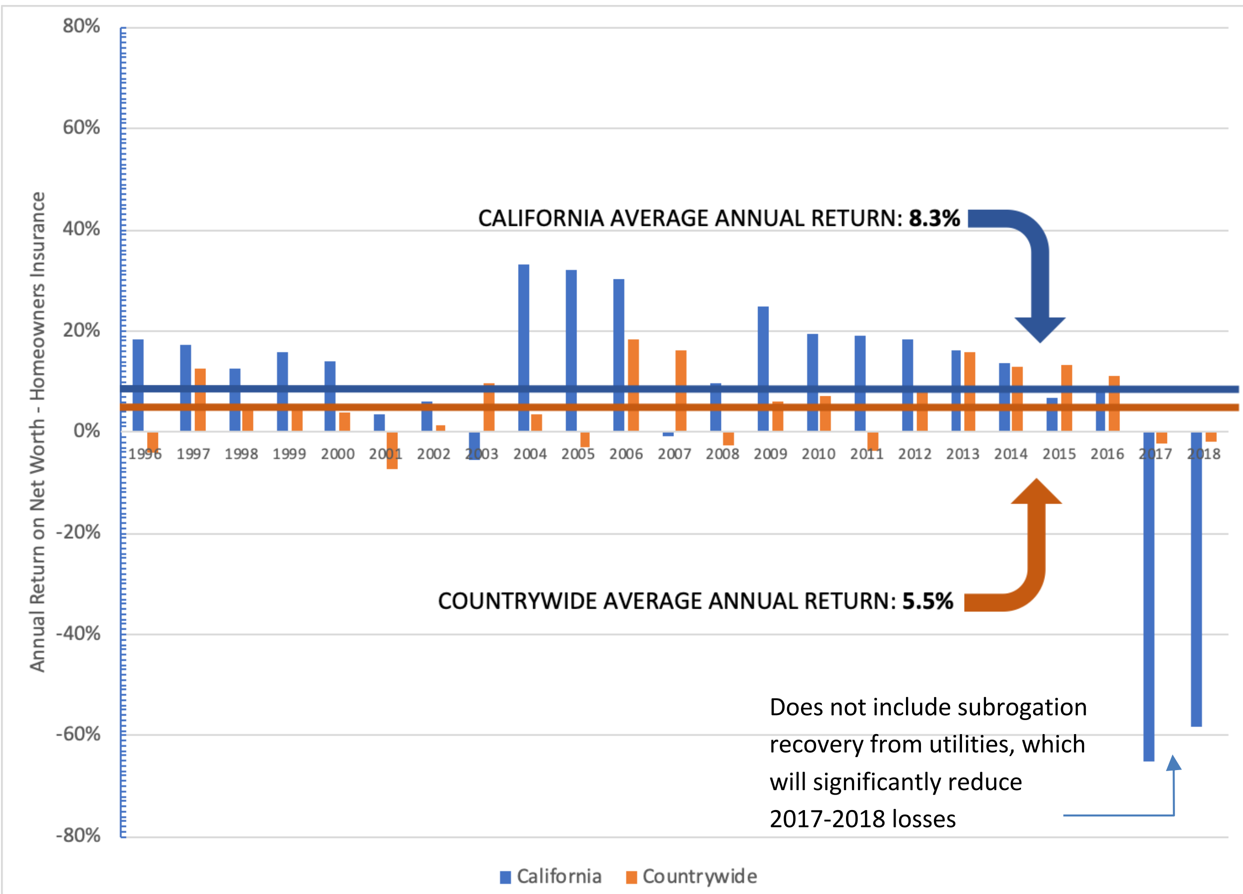
[1] Insurance Information Institute (2019). Top 10 States At High To Extreme Wildfire Risk, 2019 https://www.iii.org/fact-statistic/facts-statistics-wildfires

[2] Even after including the statewide expenditure on earthquake insurance policies, the average premium per homeowner remains below the countrywide average while providing, on average, significantly more coverage per home insured.

add unregulated reinsurance premiums into rates would neither lower rates, increase access, or reduce risk in the state; indeed, it would do exactly the opposite.

**California Homeowners Insurance is More Profitable than Countrywide Average**

While this legislative package would increase premium and profits collected by insurers, it is important to note that the relatively low rates for California homeowners under the current rules have been accomplished with excellent profit results for insurers. Despite the historic fires of 2017 and 2018, as the following graph of data from the National Association of Insurance Commissioners shows, home insurance profits in California have averaged 8.8% over a 23-year experience period, while the national average homeowner's insurance profit was 5.5% over the same period.[3]




**Once Insurers Report Wildfire Subrogation Payments from Utilities, the Profit Picture Will Be Even Better**

The California profit data include the most recent two years of wildfire catastrophes, in which massive fires created billions of dollars in insured losses. However, the NAIC reports from which the graph above is derived – and undoubtedly the information provided to lawmakers by insurers, as well – do not

[3] This calculation of Return on Net Worth includes all years of data that are publicly available from the website of the National Association of Insurance Commissioners.

account for the $11 billion settlement between California insurers and PG&E[4] or other subrogation claim payments that the insurers may receive from other utilities. Once those recoveries are recorded by insurers, a sizeable portion of the wildfires of 2017 and 2018 will be off the insurers' books. Then, their short-term losses from these years will be dramatically scaled down, and their long-term average profits will likely return to double the national average, as it has been over the past several years. In any event, it is not actuarially sound to use short- term data to measure profit in catastrophe-prone states or lines of insurance, so whether or not we account for the impending payments from utilities, California has been a profitable market for homeowners insurance companies.

**Why Allowing Reinsurance Charges to Be Passed Through to Consumers Without Review Will Result in Significantly Higher Homeowners Insurance Rates for Californians**

Reinsurance rates are not regulated in any form. Presently, under California rules, reinsurance charges may not be passed through to consumers.[5] In my actuarial opinion, just the provision of this legislative package allowing unregulated reinsurance charges to be passed through to California consumers will immediately cause rates to rise by 40%, ensuring that Californians will have to incur, at a minimum, the average rate per thousand dollars of coverage faced by states that allow this pass through. Notably, homeowners in the other states that prohibit the reinsurance pass-through also see lower premiums than the countrywide average.[6]

But not only will rates immediately jump across the board, this change will expose all California homeowners to periodic reinsurance-driven spikes in premiums of 50% or more and spates of non-renewals. Surges in the price of reinsurance often result from a major catastrophe in California or one outside of the state, like a series of hurricanes, or a tsunami on the other side of the world, or even a terrorist attack. This is because, while the homeowners insurance market is state-based, the unregulated reinsurance market is global, which means that everyone paying for reinsurance shares in the risks and exposure to catastrophes around the world. Having home insurance rates calculated on a direct basis (that is, without adding in reinsurance) as happens in California now, homeowners here are insulated from turbulence and disasters around the world. If this proposal took effect, however, Californians would lose that protection as soon as the bill became law.

**A Review of the Florida Experience After The 2004-5 Hurricanes Should Be a Stark Warning to California Policymakers.**

In the wake of the historic premium increases following the 2004 and 2005 hurricane seasons, I was retained by the state of Florida to help address the skyrocketing homeowners insurance premiums and unavailability of coverage after eight hurricanes hit Florida over a period of two consecutive years. The chief product of my work for the state came, in January of 2007, when the Florida Legislature enacted a major homeowners insurance reform law during a special legislative session. The context for this

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[4] See, for example, Lagos, M. (September 13, 2019). PG&E, Insurance Companies Strike $11 Billion Deal to Settle Wildfire Claims. KQED

[5] 10 CCR §2644.25 (a) For all lines and sublines except for those listed in the next subparagraph [earthquake and medical malpractice], ratemaking shall be on a direct basis, with no consideration for the cost or benefits of reinsurance.

[6] The average homeowners premium for a $200,000 to $299,000 home in Washington State is 34% below the countrywide average and the premium in Alaska is 25% lower than average.

emergency enactment was explained by a March 2007 report of the Florida Office of Insurance Regulation,[7] which is also attached (emphasis added):

> *While all areas of Florida were affected, property insurance premiums soared for property risks for homeowners and businesses located on the coastline. Due to the lack of availability of policies from the private insurance market, many policyholders found themselves with policies from Citizens --- the residual market.*
>
> *During public hearings held in Florida in 2006, home and business owners offered compelling testimony cataloguing ten-fold rate increases, often as a consequence of being unable to find coverage…*
>
> *State Farm Florida, the largest private insurer in Florida, increased its rates a formidable 66% during 2006 alone…*
>
> *The rising cost of reinsurance for insurance companies has been one of the primary components fueling the rate increases. Insurance companies require reinsurance to maintain solvency requirements as well as to diversify risk. The majority of reinsurers are located off-shore (the Caribbean and in Europe), and are not regulated by the State of Florida. While the recent storms have made direct insurers skittish about expanding, or even retaining their current property exposure in Florida, the storm activity has had an even greater effect on reinsurers. Over the last two years, reinsurers have significantly reduced their exposure in Florida, and nearly doubled their rates for the reinsurance that is offered.*
>
> *For many direct writers in Florida, the cost of reinsurance is an unavoidable expense, which has greatly contributed to recent rate requests….the cost of reinsurance now constitutes 40-50% of the premium dollar…*
>
> *The insurance industry readily admits the impact of reinsurance costs on premiums:*
>
> > *"Among the reasons for hefty rate increases is the cost of reinsurance, insurance for insurers. Increases in reinsurance typically have varied from 30 percent to more than 150 percent, according to one reinsurance broker, depending on the riskiness of the business being reinsured. Reinsurance costs for the 2006 hurricane season for one major Florida insurer more than tripled, compared with the same period in 2001"[8]…*
>
> *What is especially troubling from a consumer standpoint is the rate increases are not occurring in a vacuum – they are occurring during a period of record insurance industry profits which has resulted in accusations of "price gouging," by consumer groups, and some public officials.*

The report discusses many things but most relevant to our focus is "the savings from the new reinsurance made available under the Act." Because private reinsurance had become so expensive – and so much higher in price that what was actuarially sound – the state was effectively forced to become a major provider of the industry's reinsurance needs and sold a $12 billion layer of reinsurance

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[7] Florida Office of Insurance Regulation (March 1, 2007). "House Bill 1A, Presumed Rating Factors."

[8] Insurance Information Institute, website visit of February 15, 2007.

to replace the overpriced private market coverage, under the January 2007 special session law. Pursuant to that law, the insurers could purchase reinsurance from the state or the private market, but in no event could insurance companies charge more to policyholders than the cost of the state's coverage. The overall savings to consumers was estimated in the report to be 20%. That is another way of saying that the reinsurance premium passed through to consumers before the state stepped in to provide the coverage was excessive enough to lower home insurance rates relying on such reinsurance by 20 percent.[9] (An additional savings not relevant here for 4.3% was also calculated in the report.)

In Section IV, "Florida's New Legislation," of the March 2007 report, the Florida Office of Insurance Regulation explained the lengths the state had to go to combat the devastation wrought by the pass-through of private reinsurance costs [emphasis added]:

> *The bill addressed the problems of availability and affordability of private reinsurance, which has led to substantial premium increases for many Floridians and has also contributed to increases in the number of people insured by Citizens Property Insurance Corporation. Although some aspects of the implementation of this Legislation continue to evolve, this was a crucial first step to bring relief to the citizens of Florida.*
>
> *To address market dislocations in Florida, the legislation created an emergency program which will be effective through the 2009 hurricane season. The legislation requires the Florida Hurricane Catastrophe Fund to offer reinsurance coverage of up to $12 billion in addition to the $16 billion of reinsurance that would have been available for 2007 under the existing law. Insurers will now have the option to purchase this new reinsurance in $1 billion increments up to the $12 billion limit. The new legislation retains the option of allowing insurers to elect participation levels giving them 90 percent coverage, 75 percent coverage or 45 percent coverage.*
>
> *Although actuarially priced, the additional reinsurance coverage offered through the CAT Fund will be sharply lower in price relative to coverage currently being sold by private reinsurance companies. This savings can be achieved due to the elimination of profit margins incorporated into the rates of private reinsurers, as well as the CAT Fund being a government entity, which has different tax treatment than the private sector.*
>
> *Insurers are not required to purchase CAT Fund coverage but must incorporate this price savings into their rate filings. Furthermore, the legislation requires all savings from the government provided reinsurance to be passed through to policyholders, specifically, Florida homeowners and businesses.*

The bill requiring taxpayers to set up their own reinsurance system ultimately saved Florida policyholders $20 billion. However, it need never have gotten to the point where the State of Florida had to operate a massive reinsurance book of business to address the dual calamities of unbearable, across-the-board premium increases and widespread non-renewals. The primary actionable problem was the cost of reinsurance passed through to homeowners, and the emergency legislation required the state to sell a huge new layer of reinsurance to control the cost of private reinsurance in order to limit

[9] Since reinsurance was making up 50% of loss portion of the home insurance rates and the reinsurance being replaced was only for a layer of coverage, the actual excessiveness of the reinsurance being replaced was more than 50%.

the unbearable burden being thrust on consumers. The legislation under consideration in California would do precisely the opposite and allow insurers to include in customer premiums the same unregulated costs that devastated Florida after it and neighboring states faced consecutive years of hurricane catastrophes.

As you consider the extraordinary rate hikes that this bill will yield, I urge you to review a series of Pulitzer Prize winning articles on the Florida crisis by the Saratoga Herald-Tribune (https://www.pulitzer.org/winners/paige-st-john).

I briefly cite a few key sections from this series that provide a particularly relevant warning for California policymakers as they consider this legislation.

- **On the consumer cost of allowing the reinsurance pass through.**

From the article in the Pulitzer Prize winning series called "How Bermuda Rigs Rates" (emphasis added).

> *In early 2006, Florida was on the verge of a financial disaster.*
> *After two deadly hurricane seasons, major insurance carriers were leaving, smaller companies struggled to raise capital and Florida families scrambled to find coverage and pay escalating premiums.*
>
> *As they strove to recover from the eight hurricanes of 2004 and 2005, Floridians took another hit — from Bermuda reinsurance companies that seized on the crisis to double or triple their rates… The cost was paid by Florida property owners, some of whom suddenly faced premiums as high as their house payments…*
>
> *The squeeze was legal, and opportunistic.*
>
> *"That's what we saw after hurricane Andrew and that's what will happen again, in my opinion, the next time we have a major hurricane," said Steve Alexander, actuary for the office of the Florida Insurance Consumer Advocate…*
>
> *But it also was driven by a hunger to maximize profit — to, as ACE Ltd. Chief Executive Officer Evan Greenberg told investors in a 2006 earnings call, "ruthlessly take the elevator up at the right times."…*
>
> *The average cost of reinsurance coverage in Florida climbed from $9.90 per $100 in exposure to $20, the highest in the nation.*
>
> *The average home premium increased 80 percent. Residents near the coast saw increases of 300 percent. More than 300,000 Florida families lost their private coverage, forced to find a new company or join Citizens, the state-run insurer of last resort.*

- **On reduced state oversight of insurance market as premium and power is ceded to reinsurers**

From "Sending Billions Overseas," the fifth article in the Pulitzer series (emphasis added).

> *Two-thirds of property insurance premiums now leave Florida as unregulated payments to largely offshore reinsurers -- companies that sell hurricane protection to insurers and that operate without rate control or consumer oversight.*

> *They, more than state insurers and state regulators, determine how much Floridians must pay to live in the state, and whether property insurance is available at all…*
>
> *The volatile reinsurance market now has such a tight hold on Florida that homeowners and the state economy are perpetually at risk of future market shocks, even those triggered by events elsewhere in the world.…*
>
> *There is a perverse tendency for the reinsurance industry to hope for disaster.*
>
> *The cost of calamity coverage is determined mostly by supply and demand. Big disasters can temporarily dampen quarterly profits and even kill a few unlucky reinsurers, but they drive up demand and draw down capital, shrinking supply.…*
>
> *On average, the Herald-Tribune calculated, reinsurers charge five times more than the actuarial risk of loss.*

- **On how insurers avoid rate regulation by including reinsurance in rates**

From another article in the series, "How State Farm Cashed in on a Crisis" (emphasis added).

> *A Herald-Tribune investigation finds Florida's largest insurer [State Farm] has instead found an easier way to profit from homeowners desperate for coverage. And the desperation State Farm helped create allows it to command some of the highest rates in the world.*
>
> *The conduit for this back-door insurance is DaVinci Reinsurance Ltd., an offshore company with no physical office or employees of its own that sells policies to insurers to cover their storm losses.*
>
> *The virtual corporation was launched in 2001 by State Farm and a Bermuda reinsurer with which it has close ties.…*
>
> *The advantages to State Farm are clear.*
>
> *In Florida, the insurance rates State Farm can charge are regulated by the government. Profits are controlled and taxed. The potential loss from a major hurricane is measured in billions of dollars.*
>
> *DaVinci's premiums, on the other hand, are as high as the market will bear. Based in Bermuda, it avoids U.S. taxes and faces no limit on profits.*

- **On the self-dealing and unregulated nature of reinsurance markets**

From "How insurers make millions on the side," the third article in the series (emphasis added).

> *One way insurers move money out of the regulated business is by forming their own reinsurance companies. Essentially, they sell insurance to themselves.*
> *In 2007, one of the reinsurers with which United Property and Casualty did business was a Grand Cayman Island reinsurer called Caymaanz.*

*What made the transaction stand out was how much United paid for reinsurance from Caymaanz.*

*<u>In return for $6.5 million in storm protection, the Florida property insurer paid Caymaanz $6.5 million</u> -- $5.5 million for the coverage and $1 million for the purchase of Caymaanz stock.*

*If there had been a hurricane, United would have gotten back essentially what it paid in. Without a storm, Caymaanz and its owners walked away with an untaxed, unregulated profit.*

**<u>Conclusion</u>**

In my actuarial opinion, for the California Legislature to allow unregulated reinsurance charges to be passed through to consumers would result in an end to California's lower than national average home insurance prices as well as periodic price spike crises and accompanying unavailability of coverage.

I would be happy to discuss these concerns with you or your staff at your convenience.

Yours Very Truly,

J. Robert Hunter

J. Robert Hunter, FCAS, MAAA

Cc: Honorable Tom Daly
Members, Senate Insurance Committee
Hugh Slayden, Principal Consultant, Senate Insurance Committee

Attachment: Florida Office of Insurance Regulation "House Bill 1A Presumed Rating Factors" Report

# Financial Services Commission

# Office of Insurance Regulation

## House Bill 1A
## Presumed rating factors

## March 1, 2007

# ACKNOWLEDGEMENTS

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## EXECUTIVE SUMMARY

In this report, the Presumed Factors are presented by the Office as required under House Bill 1A, passed during the January 2007 special session. There are two kinds of Presumed Factors calculated: one to reflect the savings from the new reinsurance made available under the Act through the Florida Hurricane Catastrophe Fund ("CAT Fund") and the other to reflect the savings from the elimination of the 25 percent Rapid Cash Buildup provision of the previous law. The report shows, in detail, the methodology and calculation employed by the Office to determine the Presumed Factors.

Presumed Factors are the amount by which insurance companies must reduce the hurricane insurance portion of their rates under the law. Presumed factors are **not** the same as overall savings. For example, assume a homeowner had a policy with hurricane insurance cost which comprises 50 percent of the overall cost of the policy. In addition, assume the Presumed Factor for the CAT Fund reinsurance savings was 20 percent and the Presumed Factor representing elimination of Rapid Cash Buildup savings was 5 percent, a total Presumed Factor of 25 percent. The savings the consumer would enjoy in this hypothetical example is 12.5 percent (25 percent times the hurricane portion of the rate of 50 percent).

The Presumed Factors are shown in Section VIII of the report. As previously stated, these do not represent the overall savings but are the factors to be applied by insurance companies to the hurricane portion of the rates. For the convenience of the public, the Office has calculated the average savings (from both the CAT Fund Reinsurance and the Rapid Cash Buildup provisions of the law) by policy type:

| | |
|---|---|
| Overall Savings | 24.3% |
| Personal Lines Dwelling Savings | 23.9% |
| Tenants | 20.3% |
| Condo Units | 25.0% |
| Mobile Home | 26.9% |
| Commercial Dwelling | 28.7% |

The savings by region of the state are:

Percent to Total Premium

| Cat Fund Region | Personal Dwellings | Personal Tenants | Personal Condo Unit Owners | Personal Mobilehome | Commercial Residential | All Lines |
|---|---|---|---|---|---|---|
| 1 | 10.2% | 10.0% | 8.9% | 12.8% | 10.4% | 10.2% |
| 2 | 11.9% | 6.4% | 6.2% | 14.8% | 12.0% | 11.6% |
| 3 | 18.2% | 15.5% | 13.6% | 22.4% | 18.2% | 18.0% |
| 4 | 22.2% | 20.5% | 18.7% | 27.3% | 22.3% | 22.1% |
| 5 | 21.3% | 20.5% | 17.2% | 26.2% | 21.6% | 21.2% |
| 6 | 21.1% | 16.6% | 15.8% | 26.1% | 21.4% | 20.9% |
| 7 | 23.6% | 22.0% | 19.7% | 29.1% | 23.7% | 23.5% |
| 8 | 25.4% | 23.1% | 19.2% | 31.1% | 25.4% | 25.2% |
| 9 | 28.2% | 26.8% | 23.0% | 34.7% | 28.3% | 28.0% |
| 10 | 30.2% | 28.5% | 24.3% | 37.1% | 30.4% | 30.0% |
| 11 | 30.7% | 28.7% | 24.6% | 37.7% | 30.7% | 30.5% |
| 12 | 32.5% | 29.8% | 25.2% | 39.9% | 32.6% | 32.3% |
| 13 | 35.9% | 30.1% | 27.9% | 44.3% | 36.2% | 35.6% |
| 14 | 34.5% | 31.1% | 25.3% | 42.6% | 34.9% | 34.2% |
| 15 | 33.4% | 33.6% | 28.5% | 41.1% | 33.5% | 33.3% |
| 16 | 39.4% | 38.1% | 33.7% | 48.8% | 39.7% | 39.4% |
| 17 | 41.5% | 40.7% | 34.4% | 51.3% | 41.9% | 41.4% |
| 18 | 43.8% | 43.3% | 33.6% | 53.9% | 43.8% | 43.4% |
| 19 | 41.4% | 43.3% | 35.5% | 50.9% | 41.8% | 41.4% |
| 20 | 43.0% | 43.3% | 35.9% | 52.9% | 43.2% | 42.9% |
| 21 | 50.9% | 46.9% | 37.5% | 62.9% | 51.2% | 50.4% |
| 22 | 52.2% | 47.7% | 38.4% | 64.3% | 52.8% | 51.7% |
| 23 | 46.9% | 45.4% | 37.9% | 57.7% | 46.9% | 46.7% |
| 24 | 51.1% | 48.7% | 38.8% | 62.8% | 51.1% | 50.6% |
| 25 | 52.8% | 52.1% | 39.0% | 64.8% | 53.0% | 52.3% |
| Statewide | 23.9% | 20.3% | 25.0% | 26.9% | 28.7% | 24.3% |

Maps of Florida and detailed maps of certain parts of the state showing the location of the CAT Fund regions may be found at http://paragonbenfield.com/fhcf/pdf/06ratereport.pdf, starting on page 135. The CAT Fund Regions by zip code are included as Exhibit 12.

The public must be alerted to the fact that these are average savings. There are many reasons why an individual policyholder might experience a different amount of savings when a policy is renewed. One very significant reason is that the actual regional impacts are by zip code and not the broad regions listed above. Another is that the Office allows the insurance companies to make adjustments to the basis of the territorial distribution of the savings to follow the system used by the insurer in its last filing. One example of this is that some insurers capped the increases in some territories and therefore did not have all of the cost included in the premium and therefore must have a lower savings to reflect this fact. This approach is allowed provided the overall savings in the entire state reflect the Presumed Factor and the overall savings are consistent with the calculations made in this report.  An additional reason that a policyholder may not experience premium savings equivalent to these figures is that an insurer may have increased rates within the year prior to the policyholder's renewal, and they may not yet have experienced the effects of the rate increase yet.

The methods to be used by the insurance companies in making filings to adopt these Presumed Factors are enumerated in this report to allow insurers to make filings by March 15, 2007 for an effective date of June 1, 2007.

The report also discusses the history of the hurricane insurance situation in Florida since Hurricane Andrew in 1992, including the sharp rise in premium charges faced by the people of Florida and the actions taken by the Florida Legislature and by insurers to help remedy the crisis faced by consumers in the state.

The current crisis in hurricane insurance in Florida has occurred during the same timeframe the insurance industry is achieving record profits on a nationwide basis.  The increase in premiums is documented in this report as well as the impact of the historical increase in reinsurance costs in the very recent past.  The growth in the Citizen's portion of the market is discussed.  This report also demonstrates that the loss ratio in Florida is not much greater than the national average during the last 10 years.  The legislative reaction to these market elements in the recent Special Session is outlined, with particular emphasis on the Presumed Factor section of the legislation.

## BACKGROUND – THE NEED FOR LEGISLATIVE ACTION

Florida has been at the epicenter of the coastal insurance crisis for well over a decade. From Hurricane Andrew in 1992 to the more recent problems of affordability and availability for residents and businesses on America's coastlines, Florida has been in the forefront of developing a public policy solution to address these market-induced difficulties.

# I.  Hurricane Andrew

The hurricane insurance crisis in Florida began following Hurricane Andrew in 1992.  At that time, Hurricane Andrew was the largest insured loss in American history, with pre-tax payouts of $15.5 billion[1], after estimated deductions for federal tax benefits, this cost was $10.1 billion to the insurance industry.

Hurricane Andrew's impact on the property/casualty insurance industry cannot be underestimated.  The industry was truly surprised by the magnitude of  the damage, and reacted quickly to reduce risk, which included one insurer threatening to non-renew up to 300,000 homes in Florida.

[1] Insurance Information Institute,  website visited on February 15, 2007, under the Catastrophe Issues section.

The Florida Legislature responded to this threat by imposing a moratorium on policy terminations and on rate increases as the Legislature developed a comprehensive response to the crisis. The Legislature solicited input from academics, insurance company representatives, consumer groups and other interested parties to formulate a plan which included the adoption of several changes to the regulatory structure of Florida's insurance marketplace.

These changes included an overhaul of the policy structure, including the introduction of separate percentage hurricane deductibles and caps on replacement cost limits. To leverage greater governmental resources, the Legislature created a risk pool, which became the progenitor of the current Citizens Property Insurance Corporation. This entity became the "insurer of last resort" that guaranteed insurance for those who could not find insurance in the private marketplace.

Another innovation of the Legislature was the creation of the Florida Hurricane Catastrophe Fund ("CAT Fund") established in November 1993 during a special legislative session. Designed to provide a form of protection similar to reinsurance to maintain insurance capacity, the CAT Fund provided reimbursements to insurance companies, for defined levels of catastrophic losses resulting from hurricanes. Insurers writing in Florida are required to participate in the Fund, but can select their level of participation.

In 2006, the CAT Fund was authorized to offer partial reimbursement on an industry-wide level of up to $15 billion[2], following an industry-retained loss of $5.6 billion sustained during the 2004-2005 hurricane seasons. Under this program, individual insurance companies are reimbursed for either 45%, 75%, or 90% of their losses above the retention point, depending on their participation level. The CAT Fund's 2006/2007 Coverage selection report shows that 75.5% of participating companies (representing 95.5% of the CAT Fund's premiums) selected the 90% participation option.[3]

Hurricane Andrew also created a significant impact on premiums. Insurers seemed genuinely surprised by the amount of damage caused by Hurricane Andrew and scrambled to revise their hurricane models. The purpose of the changes in ratemaking techniques was to adopt computer models that projected longer timeframes of experience --- from 1,000 to 10,000 years into the future. The revised models contained projections of periods of intense activity and very large hurricanes, as well as periods of little or no activity.

While this engendered significant premium increases, policymakers in Florida, and around the nation supported these revisions as insurers promised the models' increased accuracy would bring long-term price stability. The subsequent rates were based on these long-term estimates.

With the CAT Fund in place to provide a level of catastrophic hurricane protection, the

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[2] In 2007, the limit is $16 billion.
[3] FCHF web site visited on February 19, 2007.

Office of Insurance Regulation ("Office") reported "the private insurance market had largely stabilized by the end of 2003 and into 2004."[4] This is a logical result, as insurers experience stability during periods of low storm activity. This plan worked from the intervening years between Hurricane Andrew and the 2004-2005 hurricane seasons. Yet, eight named storms reached landfall in Florida during a two-year span which tested this framework.

## II. Broken Promises and the Hurricane Activity of 2004-2005

In 2004, four hurricanes reached landfall in Florida: Charlie, Frances, Ivan and Jeanne, producing claim payments of $25.1 billion pre-tax ($16.3 billion after taxes);[5] the 2005 season featured an additional four named storms: Dennis, Katrina, Rita and Wilma which caused $10.8 billion pre-tax ($7.0 billion after taxes) of insured damage in Florida.[6]

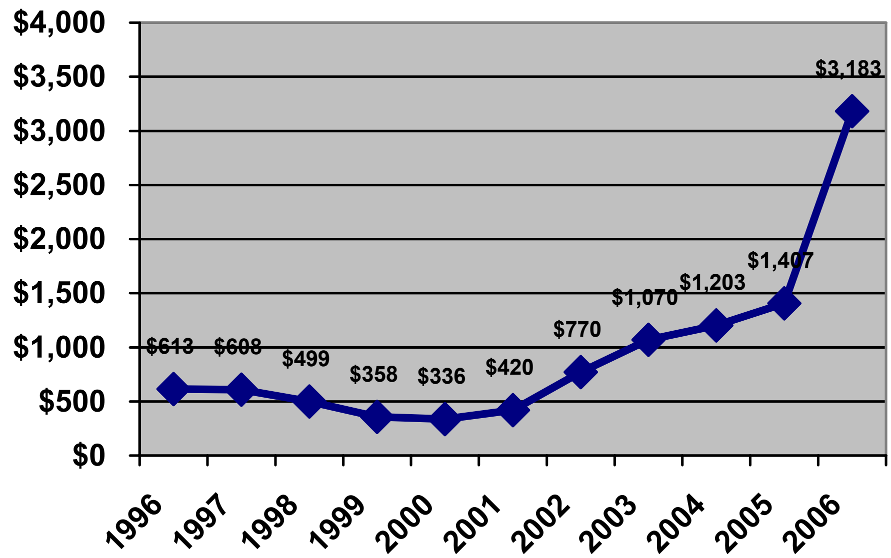
The promised stability in prices and availability of insurance vanished following the 2004-2005 hurricane seasons. While all areas of Florida were affected, property insurance premiums soared for property risks for homeowners and businesses located on the coastline. Due to the lack of availability of policies from the private insurance market, many policyholders found themselves with policies from Citizens --- the residual market.

During public hearings held in Florida in 2006, home and business owners offered compelling testimony cataloguing ten-fold rate increases, often as a consequence of being unable to find coverage, and being forced to accept a Citizens policy. Originally designed to be a supplement of insurance capacity – not a direct competitor, Citizens policies were mandated to have the insurance rates higher than the 20 largest insurers in the state.

Premium for Citizens (and its predecessor residual market entities, the Florida Windstorm Underwriting Association and the Florida Residential Property & Casualty Joint Underwriting Association) increased from $336,717,315 in December 2005 to $2,845,210,771 in September 2006, a growth of 745 percent.[7] The expansion is not just due to new property writings, but also incorporates Citizens' rate increases. The chart below demonstrates Citizens' dramatic premium growth in Florida:

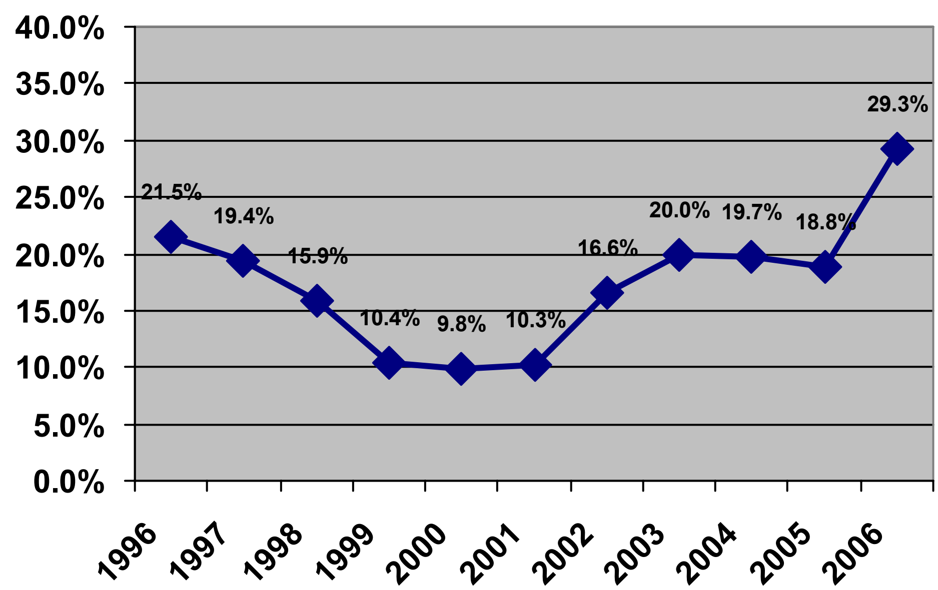
[4] The Florida Insurance Market in 2004: The Difference a Decade Makes, Florida Office of Insurance Regulation, March 2005.
[5] Hurricane Summary Data. Florida Office of Insurance Regulation, August 2006.
[6] Ibid.
[7] The increase includes rate changes as well as policy growth. The comparable policy count growth from 2000 to 2006 was from 476,957 to 1,245,183 policies.

## Citizens' Premium 1996-2006
**(in $ millions)**




The residual market has grown to represent nearly 30% of the total residential property insurance market in Florida:

## Citizens' Premium Relative to the Florida Residential Market




Not only were Floridians with policies in Citizens experiencing premium increases, but so were those who obtained insurance from the private market. As an example, this report shows rate increases for four large writers in Florida: State Farm Group, AllState Floridian, Universal Property & Casualty and American Strategic:

## State Farm Rate Increases 1997-2006

| New Business Date | Renewal Date | Percent Increase |
|---|---|---|
| 8/1997 | 10/1997 | 25.6% |
| 9/1997 | 11/1997 | 12.2% |
| 9/1998 | 9/1998 | -0.9% |
| 1/2001 | 4/2001 | 6.4% |
| 11/2001 | 1/2002 | 14.3% |
| 5/2002 | 7/2002 | 22.2% |
| 11/2003 | 1/2004 | 6.8% |
| 9/2004 | 1/2005 | 1.7% |
| 2/2005 | 4/2005 | 5.0% |
| 2/2006 | 4/2006 | 8.6% |
| 8/2006 | 11/2006 | 52.8% |
| **Cumulative Since 2002** | | **131.3%** |

## Allstate Floridian Rate Increases 2002-2006

| New Business Date | Renewal Date | Percent Increase |
|---|---|---|
| 9/2002 | 11//2002 | 16.0% |
| 1/2004 | 2/2004 | 6.3% |
| 8/2005 | 8/2005 | 8.7% |
| 10/2005 | 10/2005 | 16.3% |
| 2/2007 | 2/2007 | 8.2% |
| **Cumulative Since 2002** | | **68.7%** |

## Universal Property & Casualty Rate Increases 2001-2006

| New Business Date | Renewal Date | Percent Increase |
|---|---|---|
| 6/2001 | 8/2001 | 6.6% |
| 2/2002 | 4/2002 | 8.9% |
| 6/2003 | 7/2003 | 7.4% |
| 1/2004 | 3/2004 | 7.5% |
| 9/2004 | 9/2004 | 11.3% |
| 5/2006 | 6/2006 | 9.9% |
| **Cumulative Since 2002** | | **53.8%** |

## American Strategic Rate Increases 1998-2006

| New Business Date | Renewal Date | Percent Increase |
|---|---|---|
| 3/1998 | 3/1998 | -6.5% |
| 11/1998 | 1/1999 | -0.9% |
| 3/2000 | 5/2000 | -8.6% |
| 3/2002 | 4/2002 | 15.1% |
| 12/2003 | 12/2003 | 4.6% |
| 2/2005 | 4/2005 | 7.8% |
| 3/2006 | 5/2006 | 19.7% |
| 6/2006 | 8/2006 | 19.4% |
| **Cumulative Since 2002** | | **85.5%** |

Interestingly, American Strategic actually filed three rate decreases from 1998-2000, but this defies the trend. Instead, the private marketplace as illustrated by these four company groups has experienced multiple rate increases which have increased in frequency since the 2004-2005 hurricane seasons. State Farm Florida, the largest private insurer in Florida, increased its rates a formidable 66% during 2006 alone. Not far behind, American Strategic's two increases cumulatively totaled 43 percent during the same timeframe.

Consumers with private sector policies were not the only ones to experience rate increases. To the contrary, Floridians with policies in Citizens also endured rate hikes. Due to the merger of the two residual markets in 2002, it is difficult to produce a comparable timeline for Citizens Corporation. For the purposes of this analysis – rate increases from the Florida Wind Pool were combined with Citizens high risk (wind only) accounts, while data from the Florida Residential JUA were combined with Citizens personal lines accounts:

## Citizens' Rate Increases for Personal Lines Accounts 1997 to 2006

| New Business Date | Renewal Date | Percent Increase |
|---|---|---|
| 7/1997 | 9/1997 | 18.7% |
| 5/1998 | 6/1998 | 2.0% |
| 10/1999 | 4/2000 | 0.1% |
| 1/2002 | 5/2002 | 10.2% |
| 7/2002 | 9/2002 | 1.7% |
| 6/2003 | 8/2003 | 25.8% |
| 2/2004 | 4/2004 | 2.8% |
| 12/2004 | 2/2005 | 1.5% |
| 2/2005 | 4/2005 | 23.2% |

| | | |
|---|---|---|
| 1/2006 | 2/2006 | -0.3% |
| 4/2006 | 4/2006 | 13.3% |
| **Cumulative Since 2002** | | **104.7%** |

### Citizens' Rate Increases for High Risk Accounts 2000 to 2006

| New Business Date | Renewal Date | Percent Increase |
|---|---|---|
| 7/2000 | 7/2000 | 94.6% |
| 7/2003 | 7/2003 | 12.8% |
| 7/2004 | 7/2004 | 11.9% |
| 4/2005 | 4/2005 | 11.9% |
| 1/2006 | 1/2006 | 1.0% |
| 3/2006 | 3/2006 | 16.4% |
| 1/2007 | 1/2007 | -3.9% |
| **Cumulative Since 2002** | | **59.6%** |

The rising cost of reinsurance for insurance companies has been one of the primary components fueling the rate increases. Insurance companies require reinsurance to maintain solvency requirements as well as to diversify risk. The majority of reinsurers are located off-shore (the Caribbean and in Europe), and are not regulated by the State of Florida. While the recent storms have made direct insurers skittish about expanding, or even retaining their current property exposure in Florida, the storm activity has had an even greater effect on reinsurers. Over the last two years, reinsurers have significantly reduced their exposure in Florida, and nearly doubled their rates for the reinsurance that is offered.

For many direct writers in Florida, the cost of reinsurance is an unavoidable expense, which has greatly contributed to recent rate requests. As the following table demonstrates, the cost of reinsurance now constitutes 40-50% of the premium dollar:

**Reinsurance Cost Per Premium Dollar**
**Based on Most Recent Rate Filings**
**2006-2007**

| Sample Company Group | Reinsurance Cost |
|---|---|
| Allstate Floridian | 39.5% |
| American Strategic | 52.2% |
| State Farm Group | 40.1% |
| Universal Property & Casualty | 40.1% |

The insurance industry readily admits the impact of reinsurance costs on premiums:

> "Among the reasons for hefty rate increases is the cost of reinsurance, insurance for insurers. Increases in reinsurance typically have varied from 30 percent to more than 150 percent, according to one reinsurance broker, depending on the riskiness of the business being reinsured. Reinsurance costs for the 2006 hurricane season for one major Florida insurer more than tripled, compared with the same period in 2005."[8]

Florida Insurance Commissioner Kevin McCarty has also noted this effect:[9]

> "Given the current situation, there is little interest in an expanding investment to insure against mega-catastrophes, like hurricanes. For reinsurance contracts that have been written, private insurers are finding that costs have risen dramatically, and reinsurers are changing the conditions of their reinsurance treaties *(or contracts)* forcing insurance companies to retain more of the risk."

Based on these data, the Florida Legislature made a logical decision when it examined the reinsurance market as a source for rate relief, which if structured properly, would not require a subsidy to address.

Regardless of the reasons, the rate stability promised by the industry following Hurricane Andrew has not materialized. Some possible explanations include an overreaction by the industry (including reinsurers) to the recent spate of storm activity. What is especially troubling from a consumer standpoint is the rate increases are not occurring in a vacuum – they are occurring during a period of record insurance industry profits which has resulted in accusations of "price gouging," by consumer groups, and some public officials.

## III. Rate Increases Lead to Record Industry Profits

An analysis of the industry "strategy" as it pertains to hurricane risk reveals that insurers have increasingly shed high-risk policies. While the state insurance pools covering residential property like Florida's Citizens Property Insurance Corporation have grown substantially, the industry has engaged in a corporate strategy of reducing risk and raising premiums for residential property while expanding other lines. This has allowed the industry to achieve record profits despite the recent hurricane activity.

In 2004, the Property/Casualty Insurance industry set an industry record by netting an after tax profit of $40.5 billion. In 2005, even considering Hurricane Katrina and other major hurricanes, the industry posted a profit of $48.8 billion[10] -- a new record. In 2006,

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[8] Insurance Information Institute, website visit of February 15, 2007.
[9] Testimony before the U. S. House of Representatives Subcommittee on Housing and Business of the Financial Services Committee, June 28, 2006.
[10] The $40.5 and $48.8 billion dollar figures are from Aggregates and Averages, A. M. Best and Co., 2005 and 2006 editions.

with no major hurricane activity coupled with premium increases, the industry set yet another profit record, estimated to be $68.1 billion[11]. To put this into perspective the $157.4 billion in profit over the last three years equates to roughly $524 for every man, woman and child living in the United States, or $1,574 per household.[12]

It is true that profit from Florida's insurance market has not been as robust as in other states due to the 2004-2005 storm activity, but an analysis of loss ratios over a longer period of time, 1996-2006, demonstrates that Florida is hardly a "money pit" as often portrayed by the industry. To the contrary, during the past decade, the industry's loss ratio in Florida *(the loss ratio being the percentage of the property/casualty insurance premium dollar used to pay losses due to claims)* was less than 70 percent of the premium. If the 2006 loss ratio estimates are included, this equates to a loss ratio roughly 2% higher than the national average, which is not significant.

### Comparison of Loss Ratios
### Florida vs. the U.S.
### 1996-2006[13]

| Year | Florida Loss Ratio | U.S. Loss Ratio |
|---|---|---|
| 1996 | 58.6% | 65.3% |
| 1997 | 53.9% | 60.0% |
| 1998 | 56.1% | 65.2% |
| 1999 | 59.9% | 66.7% |
| 2000 | 63.3% | 69.4% |
| 2001 | 64.0% | 78.8% |
| 2002 | 61.3% | 68.7% |
| 2003 | 52.4% | 62.1% |
| 2004 | 115.3% | 60.4% |
| 2005 | 83.8% | 66.6% |
| 2006 | 45.4% | 54.5% |
| **1996-2006** | **66.5%** | **64.7%** |

Clearly insurers have reaped windfall profits in some lines of insurance that have offset any losses in residential and commercial property insurance in recent years. One notably profitable line is auto insurance, which experienced healthy profits. From an economic standpoint, the recent storm activity caused only an aberration in industry profitability that was more than offset by profits from other states, and in other lines of insurance. The recent rate increases have also helped ameliorate any potential discrepancies between the premium collected and the risk assumed.

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[11] Review/Preview, A. M. Best and Co., January 2007.
[12] U.S. Census Bureau, Projections of the Number of Households and Families in the United States: 1995 to 2010.
[13] Aggregates and Averages, *A.M. Best Co*. 1997 to 2006; edition 2006. Estimated for Florida by the Office for USA by *Best's Review/Preview*, January 2007.

The insurance crisis experienced by Floridians is not a result of insufficient premiums or a collapsing insurance marketplace. Instead the crisis has been created by the actions of insurance companies which have coupled rate increases with reduced availability. These actions have created a crisis of affordability and availability in Florida, as well as placed more pressure on the Citizens Property Insurance Corporation to accept risk. These are the factors that prompted the Governor and Florida Legislature to enact changes to the insurance market structure during the 2007 Special Legislative Session.

# IV. Florida's New Legislation

In response to the insurance crisis, the Florida Legislature passed House Bill 1A, which Gov. Crist signed into law on January 25, 2007 attached as Exhibit 11 in the technical appendices. The Legislature stated its rationale for this legislation:

> "WHEREAS, homeowners in the State of Florida are struggling under increased insurance costs and increased housing prices as a result of damage caused by hurricanes and tropical storms, and
> WHEREAS, this increase in the cost of property insurance for the state's residents demands immediate attention, and
> WHEREAS, the affordability of property insurance creates financial burdens for Florida's residents and financial crises for some property owners, and
> WHEREAS, in addition to affordability, the availability and stability of property insurance rates are critical issues to the residents of this state, and
> WHEREAS, because there is no single, quick, or easy solution to the current crisis, a comprehensive and creative approach is required, and
> WHEREAS, property insurance is so interwoven with other forms of insurance, through business, regulation, advocacy, purchasing, and other interactions, that the viability of the insurance market in Florida is at risk, and
> WHEREAS, expanding coverage offered by the Florida Hurricane Catastrophe Fund can help to address this crisis, and…
> WHEREAS, strengthening the processes for establishing property insurance rates can help to address this crisis, and…"

Insurance Commissioner Kevin McCarty identified two critical outcomes of this legislation[14]:

- The Bill Increases Reinsurance Capacity by creating more options for private industry to purchase reinsurance at a more inexpensive rate. This is critical as reinsurance costs have been one of the primary drivers contributing to rate increases in 2006.

- The Bill Shifts Some Risk to the Public Sector. In fact, the bill nearly doubles the commitment of the Florida Hurricane Catastrophe Fund.

In addition, the new law will allow Citizens to have actuarially sound rates that are lower than rates charged by the private sector, and will allow easier access to Citizens' policies.

[14] State of the Florida Market, January 30, 2007.

By passing this bill, the Florida Legislature adopted comprehensive and far-reaching reforms. The bill addressed the problems of availability and affordability of private reinsurance, which has led to substantial premium increases for many Floridians and has also contributed to increases in the number of people insured by Citizens Property Insurance Corporation. Although some aspects of the implementation of this Legislation continue to evolve, this was a crucial first step to bring relief to the citizens of Florida.

To address market dislocations in Florida, the legislation created an emergency program which will be effective through the 2009 hurricane season. The legislation requires the Florida Hurricane Catastrophe Fund to offer reinsurance coverage of up to $12 billion in addition to the $16 billion of reinsurance that would have been available for 2007 under the existing law. Insurers will now have the option to purchase this new reinsurance in $1 billion increments up to the $12 billion limit. The new legislation retains the option of allowing insurers to elect participation levels giving them 90 percent coverage, 75 percent coverage or 45 percent coverage.

Although actuarially priced, the additional reinsurance coverage offered through the CAT Fund will be sharply lower in price relative to coverage currently being sold by private reinsurance companies. This savings can be achieved due to the elimination of profit margins incorporated into the rates of private reinsurers, as well as the CAT Fund being a government entity, which has different tax treatment than the private sector.

Insurers are not required to purchase CAT Fund coverage but must incorporate this price savings into their rate filings. Furthermore, the legislation requires all savings from the government provided reinsurance to be passed through to policyholders, specifically, Florida homeowners and businesses.

To meet these new requirements, the legislation requires each insurer writing residential property insurance in Florida to make two rate filings. The first filing must reflect the Office of Insurance Regulation's initial estimate of savings generated under the act. To accomplish this objective, the Office will promulgate a "presumed factor" to reflect savings for the industry.

Shortly after the "presumed factor" filing, insurers are required to make a second filing under the Office's "file and use" law. This filing will "true up" the savings used by the insurer in the initial filing to reflect the actual reinsurance savings. The Legislature deemed these two filings necessary to accelerate the rate savings. Due to time constraints, it is not possible to calculate savings for hundreds of insurers so the Florida Legislature utilized the "presumed factor" approach as a first estimate. Subsequent to this filing, the "true-up" filings will most likely result in upward or downward adjustments based on actual savings.

## V. Purpose of this report – outline of contents

This report will develop the presumed factor to be used by all residential property insurance companies. The methodology used to calculate the presumed factor will be explained, followed by the actual calculation. This will be followed by a discussion of how insurance companies should apply the factor to prepare their filings for an effective date of June 1, 2007. Finally, the report will discuss how insurance companies should prepare their filings to test the appropriateness of the presumed factor and to prepare "true up" filings to bring their rates into full compliance with the new law. This will enable the officers of the insurance companies to sign a certification as part of the filing.

# VI. Methodology

In mathematical terms, the calculation of a presumed factor is straightforward. It is derived by determining the savings that will result by replacing private reinsurance (currently priced at historically high levels) with reinsurance offered by the state through the Florida Hurricane Catastrophe Fund.

The fact that different private insurers have different reinsurance plans adds to the complexity of these calculations, and requires analysis to determine an estimate of what exactly is being replaced by the CAT Fund and the cost savings associated with that replacement. It is beyond the Office's resources to review all private reinsurance contracts during the limited timeframe specified by the Florida Legislature. Therefore, this report is based upon a sample of twelve insurance companies' reinsurance arrangements, and a calculated rate on line. The companies in the sample include State Farm Florida, Allstate Floridian, Nationwide, Universal Property and Casualty, Universal of North America, St. Johns, American Strategic, Cypress, Florida Family, United Property and Casualty, Teachers and Southern Fidelity.[15]

The Office obtained information from the CAT Fund about each company's CAT Fund premium paid in 2006 and used the CAT Fund payout multiple to determine the 2006 coverage that each insurer purchased from CAT Fund. The Office calculated the insurer's retention, using the CAT Fund multiple for the 90 percent purchase option. The Office determined the 2006 total limit of coverage by adding the retention to the coverage below the CAT Fund retentions.

For this primary calculation, the Office assumed the insurer would purchase the entire $12 billion of new coverage from CAT Fund in addition to the $16 billion already available. As stated previously, the new law requires a savings calculation even if an insurer does not purchase the new coverage.

The Office calculated the insurer's portion of the new $12 billion in coverage using 2006 distributions of coverage below CAT Fund. New retention levels related to this new reinsurance were also calculated. The Office made a determination of the impact of the current insurer reinsurance based upon the information provided, and performed this determination by layer from the rate filing materials and reinsurance contracts of each insurer.

[15] The Office also attempted to review the reinsurance and securitization (CAT Bond) arrangements for USAA. Due to time constraints, the Office determined that due to these complex arrangements it would not be proper to include USAA in the analysis.

Using the premium from these privately secured reinsurance contracts, the Office calculated a rate on line[16] ("ROL") for each insurer for the private reinsurance to be replaced by the new CAT Fund reinsurance. During this analysis, the Office utilized the private reinsurance programs pertained to Florida exposures. The new legislation will impact the various contract entries expanding coverage provided by the CAT Fund, either by reducing (or eliminating) company dependence on the private sector for similar coverage, or by increasing the attachment points[17] of the "private" contracts.

The Office made no adjustment for limits less than 100% or for any incomplete placement of the layers involved. Furthermore, the Office considered only "first event" occurrence limits and premium, disregarding any reinstatement premium provisions and/or any other contract types that companies may have purchased to supplement the basic catastrophe programs, including those contracts covering exposures under the CAT Fund retentions. Once the Office determined the rate on line for the reinsurance to be replaced, the Office had to determine the comparable rate on line for the Florida Hurricane Catastrophe Fund. The CAT Fund's administrator, Paragon/Benfield, performed the calculation and supplied it for this report.

The presumed factors were actuarially distributed using a variety of methods. First, the factors were calculated for the 25 regions of the state adopting the same regions utilized by CAT Fund in its ratemaking.[18] The factors for each region were divided actuarially by coverage option, since an insurer can purchase the TICL coverage in 12 different layers from $1 billion up to $12 billion.

Finally, these calculations were undertaken for the five sub-lines of property insurance affected by the law, Personal Residential Dwelling, Personal Tenants, Personal Condo Unit-Owner, Mobile Home and Commercial Residential.

The Rapid Cash Buildup is shown as a separate presumed factor using actual information from the CAT Fund premium by geographic region subline to reflect the 25 percent being eliminated. This is in addition to the savings generated from the presumed factor for the TICL option.

## VII. Calculation of Presumed Factors

In this section of the report, the Office calculates the presumed factors insurers will use in preparing the rate filings to implement the savings authorized by the Florida Legislature. The calculations underlying these presumed factors are displayed.

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[16] Rate on line or ROL is the price quoted as a percentage of the limit purchased. A 20 percent ROL would, for example, indicate that the premium for a $1 million layer of coverage would be $200,000.

[17] That is, causing the coverage in a layer of private reinsurance coverage to start at a higher dollar amount, which means the coverage for that layer will be less and will cost less.

[18] A list of the regions is attached as Appendix Exhibit 9.

**Calculation of the Presumed Factors for Reinsurance Savings.**

The first step is the calculation of the rate on line ("ROL") for the sample of private insurers which is included in Exhibit 2 in the technical appendices.

The Office analyzed the sample to determine a reasonable ROL to use for the entire industry. The Office noted that State Farm, with a very low ROL due to transactions with its affiliates, was not representative of the "normal" reinsurance market and was almost half of the premium volume of the sample. Therefore we considered the following data derived from the above sample:

| | |
|---|---|
| ROL including State Farm as reported, 47% of the sample | 17% |
| ROL excluding State Farm | 24% |
| ROL giving State Farm 10% of the total sample weight | 23% |
| ROL giving State Farm 20%of the total sample weight | 21% |
| Median ROL from the sample | 19% |
| Simple average ROL from the sample (unweighted) | 21% |
| Mid point of range of the sample (10% to 40%) | 25% |
| Simple average of the above estimates of the ROL | 21% |
| Median of the above estimates | 21% |

As our analysis did not include adjustments for limits less than 100% or for any incomplete placements for the layers involved, the Office determined that a reasonable estimate of the ROL for the private reinsurance being replaced by the new CAT Fund layer is 20 percent.[19]

This must be compared to the ROL of the CAT Fund for the newly available layers of reinsurance. The calculation of the ROL, supplied to the Office by the CAT Fund is displayed in Exhibit 3 in the technical appendices.[20]

The Office needs to estimate the percentage of premium for the hurricane risk to calculate the presumed factors. The estimate, based upon the ISO filings, follows:

[19] It should be noted that the estimate of this ROL made during the special session by Paragon/Benfield, the CAT Fund's vendor, was also 20 percent.

[20] Estimates for 2007 program provided by the CAT Fund. These rates are not expected to be submitted for approval with the State Board of Administration until April 2007.

OFFICE OF INSURANCE REGULATION
INDUSTRY HURRICANE PERCENTAGES SUMMARY
USED IN PRESUMED FACTOR FOR CAT FUND
SOURCE APPROVED ISO FILING 05-00788
TOTAL HOMEOWNERS

| Form | Premium* | Hurricane Percentage** |
|---|---|---|
| Dwelling | 5,822,679,730 | 51.0% |
| Tenant | 60,263,113 | 42.3% |
| Condo-Unit | 461,151,085 | 52.0% |
| Total | 6,344,093,928 | 51.0% |

* June 2006 Quarterly Supplemental reports
** Detail calculation from ISO filing

The factors must also be divided by subline (i.e., Residential, Tenants, Condo Units, Mobile Home and Commercial). The basis for this division is outlined in Exhibit 4 of the technical appendices.

The comparison of the cost of private reinsurance being replaced and the CAT Fund reinsurance replacing it is critical to the development of the presumed factors. The calculation of the presumed factors is displayed in Exhibit 5 of the technical appendices.

In the next section of the report titled, “the Presumed Factors,” we display the presumed factors by subline, divided into region of the state and by the limit of new CAT Fund layers purchased by the insurer. To divide the presumed factors by this methodology, we had to estimate the regional impact as well as the impact by layer.

The impact by layer and subline was calculated as shown in Exhibit 6 of the technical appendices.

The first step was to compare the CAT Fund territories with ISO territories to make estimates of how the two territorial systems would interrelate. The following determinations were made:

OFFICE OF INSURANCE REGULATION
HB/SB 1A CAT FUND PRESUMED
FACTOR
ALLOCATION OF ISO TERRITORIES TO 2007 CAT FUND REGIONS

| ISO Territory | Cat Fund Region | Comments | Territory Description |
|---|---|---|---|
| 5 | 21 | | Remainder Monroe |
| 7 | 18 | | Key West |
| 10 | 13 | | Remainder Martin |
| 12 | 9 | Avg of 1,3,4,5,7,8,10,11,12,13,14,16 | See attached summary |
| 18 | 17 | Avg of 16,17 | Indian River and Martin east of intercoastal |
| 30 | 23 | Avg of 21,22,24,24,24,24,25 | Miami Beach |
| 31 | 22 | | Miami-Dade east of intercoastal |
| 32 | 20 | Avg of 15-25 range | City of Miami |
| 33 | 12 | Avg of 12,14,14,12,15,12,11,10,11,11 | Hialeah |
| 34 | 16 | | Remainder Miami-Dade |
| 35 | 17 | Avg of 9-24 range | Fort Lauderdale,Hollywood |
| 36 | 22 | | Broward east of intercoastal |
| 37 | 13 | | Remainder Broward |
| 38 | 14 | | Remainder Palm Beach |
| 39,40 | 1 | | Jacksonville and Remainder Duval |
| 41 | 2 | | Duval east of intercoastal |
| 42 | 13 | | Pinellas west of intercoastal |
| 43 | 6 | | Remainder Escambia |
| 44 | 8 | | Remainder Brevard |
| 45 | 6 | Avg of 1,3,4,5,7,8,10,11 | See attached summary |
| 46 | 11 | Avg 8-14 range | St Petersburg |
| 47 | 7 | Avg of 4-9 range | Tampa |
| 48 | 5 | | Remainder Hillsborough |
| 49 | 2 | | Orlando |
| 50 | 3 | | Polk |
| 51 | 3 | Avg of 2-3 range | Osceola,Seminole |
| 52 | 2 | Avg of 1-2 range | See attached summary |

The summaries for the three ISO territories (12, 45 and 52) as show in Exhibit 7 of the technical appendices.

We estimated the industry loss cost relativity by CAT Fund Region as described in Exhibit 8 of the technical appendices:

8A – Dwelling[21]
8B – Tenants
8C – Condo Unit Owners

Finally, we calculated relativities by CAT Fund Region for distributing the presumed factors, as show in Exhibit 9 of the technical appendices as follows:

[21] Includes Mobile homeowners and Commercial Residential.

9A – Dwelling
9B – Tenants
9C – Condo Unit Owners
9D – Mobile Home Owners
9E – Commercial Residential

Using the above information, we calculated the presumed factors to be used by insurers in making their presumed factor filings for an effective date of June 1, 2007. The calculation of presumed factors by CAT Fund Region and by TICL limit is shown in this series of Exhibits by subline. These are to be used by the insurers in conformity with the Order of the Office in Case No. 89321-07, dated February 19, 2007 in Exhibit 10.

**Calculation of the Presumed Factors for Rapid Cash Buildup**

The legislation also eliminated a 25 percent "rapid cash buildup" in the CAT Fund. This requires another presumed factor calculation to reflect this law change. The calculation of the effect of removing this 25 percent additional charge as follows:

OFFICE OF INSURANCE REGULATION
HB/SB 1A CAT FUND PRESUMED
FACTOR
STATEWIDE ALL LINES CALCULATION
CASH BUILDUP PRESUMED FACTOR

| | |
|---|---|
| 2006/2007 CAT Fund premium including cash buildup (1) | 1,068,312,780 |
| 25% Cash buildup impact on CAT Fund premium | 213,662,556 |
| Percent of CAT Fund premium relative to Citizens | 36.7% |
| 25% Cash buildup impact excluding Citizens | 135,248,398 |
| Industry Hurricane Premium (2) | 3,582,631,652 |
| Percent to Hurricane Premium cash buildup | 3.8% |
| Industry variable expense ratio (3) | 23.4% |
| Industry fixed expense ratio (4) | 6.3% |
| Indicated presumed factor to hurricane premium cash buildup | 4.4% |

(1) From Payout Multiple Report 2006/2007 from Cat Fund website
(2) From TICL Layers presumed factor calculation
(3) From State Farm, Allstate Floridian, Universal P&C and American Strategic latest approved HO filings
(4) From State Farm, Allstate Floridian, Universal P&C and American Strategic latest approved HO filings

The presumed factor distributed by subline is as follows:

OFFICE OF INSURANCE REGULATION
HB/SB 1A CAT FUND PRESUMED FACTOR
STATEWIDE SUBLINE CALCULATION
CASH BUILDUP PRESUMED FACTOR

| Subline | Relativity | Presumed Factor |
|---|---|---|
| Residential | 0.975 | 4.3% |
| Tenants | 1.000 | 4.4% |
| Condo Units | 1.000 | 4.4% |
| Mobilehome | 1.100 | 4.8% |
| Commercial | 1.200 | 5.3% |
| Total | 1.000 | 4.4% |

## VIII. Presumed Factors

The presumed factors adopted by the Office for the filings to be made by the insurers effective June 1, 2007 are included in Exhibit 1 of the Technical Appendices as follows:

1A – Dwelling
1B – Tenants
1C – Condo Unit Owners
1D – Mobile homeowners
1E – Commercial Residential

## IX. How Insurance Companies Should Apply the Presumed Factors in the June 1, 2007 Presumed Factor Filing

Now that the Office has published the Presumed Factors, two filings are required: A "Presumed Factor" filing, and a "True-up" filing[22].

Insurers must make a presumed factor filing on or before March 15, 2007. The insurers may use a "short form" filing adopting the Presumed Factors as shown in this report. This should be a separate filing using the process established in the I-file system specifically for Presumed Factors. The insurers may make a "long form" filing using the Presumed Factors that reflect a rate decrease that takes the Presumed Factors into account, but does not adopt the Presumed Factors. The rate decreases for the Presumed Factor filing are required by law to be effective for any policies written or renewed on or after June 1, 2007.

[22] See Order in Case No. 89321-07, adopted by the Office on February 19, 2007 for precise details about how these two filings are made see Exhibit 10.

A Presumed Factor filing that adopts the Presumed Factors will only reflect the effects of the Presumed Factors on the rates currently in effect and the elimination of the 25% rapid cash buildup portion of the insurer's Florida Hurricane Catastrophe Fund premium. These "short form" filings are those filings where the insurer can click "Yes" to the question on the I-file System prompt that asks "Is this filing adopting the OIR Presumed Factors and only reflecting the effects of these factors? Filers should know that it is appropriate to click "Yes" and file a short form filing if the filer merely adjusts the territorial Presumed Factors to reflect the filer's own territorial definitions and adjustment of rating factors including base rates as required by the filer's rating system.

A Presumed Factor filing will be made under the "use and file" system and must include all information used in preparing the filing including copies of all reinsurance treaties. This "long form" filing will be required when an insurer clicks "No" to the question in the above paragraph. Such filings are subject to credits and refunds if the Office determines the rate reductions are inadequate. This use and file filing is to be accompanied by a sworn statement from the chief executive officer or chief financial officer of the insurer and the chief actuary or actuary preparing the filing that the filing contains all information used to prepare the filing, includes all the reinsurance treaties, reflects all premium savings that are reasonably expected to result from legislative enactments and are in accordance with generally accepted and reasonable actuarial techniques. The sworn statement must further assert the filing does not contain any untrue statements of a material fact nor does it omit to state a material fact. This "long form" filing can reflect the filer's method of distributing the hurricane reinsurance costs by region as reflected in the most recent approved filing the insurer made for subline rates.

Either of these two filing approaches satisfies the requirements of Emergency Rule 69OER07-1 as it relates to the filing required before an insurer may non-renew or cancel or continue the non-renewal or cancellation of personal residential insurance policies, provided that, consistent with s.627.4133 (2)(c), Florida Statutes, the policyholder receives at least 100 days written notice excluding any time between the effective date of the Emergency Rule and the date of the insurer's Presumed Factor filing. Approval of the filing is not necessary to comply with the filing requirements of the Emergency Rule**.**

## X. How Insurance Companies Should Test the Presumed Factors in Later "True-Up" Filings

After making the Presumed Factor filing, insurers shall make a "True-Up" filing pursuant to the "file and use" provisions of Florida law. This filing must be a complete rate filing reflecting the reductions in loss exposure to the insurer due to all of the provisions of HB1A and the anticipated 2007 reinsurance program. The sworn statement required by HB 1A shall accompany the "True-Up" filing.

The "True-Up" filing shall contain a complete description of the reinsurance program for each company for the 2007 Hurricane Season, including the following:

a) A schematic diagram of all reinsurance coverage, including contract retentions and limits, for both the CAT Fund and private placements.

b) A listing of all reinsurance contracts, including retentions, limits, estimated ceded premium and rates on line (i.e. premium as a percentage of limits) for each contract.

c) Documentation for each contract, either in the form of a treaty or if the treaty is not yet available, in the form of a "reinsurance slip."

The "True-Up" filing may be made at any time after the insurer has submitted its Presumed Factor filing, but shall be made within 90 days from the date of the Presumed Factor filing for insurers with confirmed reinsurance in place for the 2007 Hurricane Season. For all other insurers, the "True-Up" filing shall be made within 90 days from the insurer's receipt of the broker or reinsurer confirmation of new or revised terms of the insurer's reinsurance agreements for the 2007 Hurricane Season, but in no event later than September 30, 2007.

For those insurers who have reduced rates since the enactment of HB 1A, an allowance will be made in the Presumed Factor filing for those early rate reductions.

The new law requires companies to price their products as if they took full advantage of the CAT Fund layers whether they actually bought those layers or not, and it prohibits any extra costs from being passed to policyholders if companies choose to buy reinsurance from more expensive, private sources. Given these new provisions, it will be necessary as part of the insurance company's actuarial review of the filing, to confirm that layers do not overlap the CAT Fund or, if they do, that costs have been backed out of the indicated rate need.

# XI. Technical Appendices

Exhibits follow.