



Guidance on Financial Stability Ratings[®] and Catastrophe Reinsurance Program Reporting for Florida Property Insurers

2014 Update and Addendum

December 9, 2014 (Revised)

Introduction

The Demotech discussion document, *Guidance on Financial Stability Ratings and Catastrophe Reinsurance Program Reporting for Florida Property Insurers*, published in March 2010, and its updates remain in effect as a summary of our procedures and philosophy. This communication serves as an update and addendum to reduce to writing refinements that we believe to be necessary given the changes in the marketplace and reinsurance community. The purpose of this update is to provide insight on our current requirements and other matters we believe to be relevant to a property insurance company's catastrophe reinsurance program.

Quarterly Review Update – Third Quarter 2014

Demotech has completed our review and evaluation of the third quarter 2014 financial results for rated companies writing property insurance in Florida. Financial Stability Ratings[®] (FSRs) have been affirmed as appropriate on our website, www.demotech.com. We will begin the review and evaluation of year-end 2014 financial statements as soon as they are filed and forwarded to us.

During the past year, several companies have taken advantage of Citizen's effort to further reduce its number of policyholders. Participation in takeouts, as well as experiencing organic growth, has resulted in explosive premium growth for some. Demotech recognizes premium growth can be attributed to both rate and exposure. However, our concern is that this growth has taken place during a relatively soft catastrophe reinsurance market. Should the current CAT reinsurance market experience future pricing pressure, companies with significant growth may find it difficult to afford a catastrophe reinsurance program acceptable to Demotech.

Catastrophe Reinsurance Programs Containing Catastrophe Bonds

Catastrophe bonds have become more prevalent in the catastrophe reinsurance market. Demotech recognizes the role these non-traditional loss funding vehicles provide to those companies covering the peril of wind. The following outline provides our expectations and the required information to allow Demotech to adequately review and evaluate a client company's CAT bond program.



Included with the outline is guidance regarding features of the company's specific CAT bond program that Demotech deems appropriate regarding qualification for a Financial Stability Rating[®]. As with any guideline provided, nothing Demotech presents should be viewed as a safe harbor or bright-line indicator for an acceptable CAT bond structure with respect to a company's overall catastrophe reinsurance program.

While it is not our intent to over-simplify the CAT bond issuance process, we have separated our requirement request into two distinct areas:

- Reinsurance Agreement
- Reinsurance Trust Agreement.

Reinsurance Agreement

Demotech requires specific information for the Sponsor (insurer and a Demotech rated client) regarding the establishment of a Special Purpose Insurer (SPI) for the purpose of sponsoring the issuance of a CAT bond. We are interested in management's analysis and evaluation supporting the decision of funding CAT losses through a CAT bond reinsurance agreement and request management provide a narrative with supporting documentation.

Supporting information must include a copy of the Reinsurance Agreement between the company and the reinsurer/SPI. In addition, Demotech requires evidence supporting the proper establishment and licensing of the SPI. This requirement can be satisfied via a letter from the insurance manager or administrator of the SPI or via the respective certificate from the SPI's regulator.

Reinsurance Trust Agreement

Demotech requires specific information for the Beneficiary, the Grantor and the Reinsurance Trustee. Supporting information must include a copy of the Reinsurance Trust Agreement including specific information regarding permitted investments.

Other Considerations

In addition to the required documents referenced above, the following represent criteria management should consider when contemplating sponsoring a SPI for the purpose of issuing a CAT bond:

- Demotech requires that the event trigger be indemnity based (no basis risk).
- Due to the nature of a CAT bond, management will be required to provide Demotech a narrative regarding replacement of the fund should an early season storm exhaust the CAT bond.
- Investment guidelines must include restrictions for holding highly liquid, investment grade only securities as stipulated in the Reinsurance Trust Agreement.



Summary

Demotech strives to maintain relative consistency as well as evaluation transparency in its review of property writers' catastrophe reinsurance programs. If a client company incorporates a CAT bond in its catastrophe reinsurance program, Demotech requires the following:

- A management narrative on factors considered in issuing a CAT bond
- A fully executed copy of the Reinsurance Agreement
- A fully executed copy of the Reinsurance Trust Agreement
- A management narrative on the replacement of the CAT bond
- An illustrated structure chart of the reinsurance program displaying and describing the CAT bond.

The requirement to provide the above items is relevant and pertinent to our review, evaluation and assignment of Financial Stability Ratings[®].

The purpose of this update is to communicate the evolution of our data call requirements and other items relevant to a company's catastrophe reinsurance program renewal efforts. As with the originally published *Guidance on Financial Stability Ratings[®] and Catastrophe Reinsurance Program Reporting for Florida Property Insurers*, nothing in this addendum should be considered or interpreted as a safe harbor or bright-line indicator for acceptable financial performance. If you have any questions, please contact Bob Warren, Barry Koestler or me. We can be reached at (800) 354-7207, Bwarren@demotech.com, bkoestler@demotech.com or jpetrelli@demotech.com.

Thank you.

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