



# Demotech, Inc.

## **Mitigating the Impact of Catastrophic Storms on the State of Florida**

After Hurricane Andrew made landfall in 1992, the State of Florida experienced eleven insurer insolvencies. Although none of these carriers had been reviewed or rated by Demotech, Inc., the majority of these carriers were reviewed and rated by other rating services. One of the results of the storm and subsequent insolvencies was the dislocation of Florida's property insurance marketplace. In an effort to stabilize the property insurance market, the State of Florida encouraged homegrown insurers and developed state assisted programs which today include Citizens Property Insurance Corporation and the Florida Hurricane Catastrophe Fund.

In 1996 to assist Floridians and domestic insurance companies, Demotech, Inc. was invited to review and rate start-up insurers. Demotech has reviewed and rated virtually all of the homegrown Florida domiciled insurers. Our efforts have focused on the assignment of Financial Stability Ratings<sup>®</sup> (FSRs) to financially stable insurers, including start-ups as well as established insurers. Over the past several years, legislative and statutory changes in Florida, turmoil in the global financial markets in conjunction with a nationwide decline in residential real estate values and other economic factors have resulted in an increased focus on the financial stability of Florida's property insurers.

In Demotech's on-going efforts to assist financially stable insurers, our quarterly review process includes an interactive review and analysis related to the quality and quantity of the catastrophe reinsurance program purchased by the carriers that we review and rate. To familiarize interested third parties with Demotech's efforts and observations, we prepared this brief summary of our 2011 and 2012 reinsurance analyses.

Although this communication was in large part authored by Joseph L. Petrelli, President, Demotech, Inc., requests for information should be directed to Robert M. Warren, CPCU, CPA, Client Services Manager, at [bwarren@demotech.com](mailto:bwarren@demotech.com).



## **Homeowners Insurance Marketshare**

Currently, the top two writers of Florida Homeowners insurance are Citizens Property Insurance Corporation and State Farm of Florida. These two insurers write approximately 30% of the Homeowners insurance premium in Florida. Although Demotech does not review, rate or follow these two insurers, we currently review, rate and follow 48 insurers writing the majority of the remaining 70% of Florida's Homeowners direct premium written.

See Attachment 1 for a comparison of the direct written premium for Homeowners insurance, as reported for calendar year 2010 versus 2011. Attachment 2 presents the number of insurers that Demotech reviewed, rated and followed in calendar year 2010 versus 2011, as well as the number Demotech currently rates. Attachment 3 presents the percentage of direct premium written by the carriers reviewed, rated and followed by Demotech.

## **Florida Domiciled Carriers**

Private insurers must comply with all regulatory rules and procedures. These insurers must observe and comply with regulatory rules such as financial reporting, reinsurance collectability and other regulatory bulletins. Concurrently, private insurers including those that specialize in a particular state are usually scrutinized, at least quarterly, by independent rating services.

Although State Specialists rely on the quality and quantity of their reinsurance protection to effectively compete against larger carriers, they must also retain balance sheet integrity to sustain their FSR. When operating results do not sustain policyholder's surplus or when reported financial results do not meet our requirements, Demotech will request a capital infusion of a magnitude that is reasonably necessary to bridge the time period required to obtain an improvement in operating results through changes in procedures, processes or rate level. Based on 2010 and 2011 calendar year reviews, carriers infused more than \$268,000,000 to sustain their FSRs. Refer to Attachment 4.

## **Catastrophe Modeling**

The Florida Commission on Hurricane Loss Projection Methodology was created during the 1995 Legislative Session as an independent panel of experts to evaluate computer models and other recently developed or improved actuarial methodologies for projecting hurricane losses. The Legislature specifically determined that reliable projections of hurricane losses are necessary to ensure that rates for residential property insurance are neither excessive nor inadequate. In addition, they determined that computer modeling has made it possible to improve upon the accuracy of hurricane loss projections.

Although Demotech does not endorse or require an insurer to utilize a particular hurricane loss projection modeling company, we do consider what version a company uses to submit outputs from its selected model. Attachments 5 and 6 summarize the catastrophe models that carriers utilized to evaluate their 2011 and 2012 exposure, respectively.



## **How Much Reinsurance Protection is Enough Protection?**

In his April 9, 2010 communication to Florida's media outlets, Insurance Commissioner Kevin McCarty urged the public not to be swayed by alarmists who stress a need to raise premiums because of the roughly 1% likelihood of a once-in-a-century catastrophe. Although reporters and commentators worry about a mega-catastrophe or a 1-in-100 year storm, the odds of this occurring are obviously remote. Given the cost of catastrophe reinsurance, we certainly appreciate the financial impact of his observation. However, despite the limited likelihood, Demotech requires each carrier that it reviews and rates to purchase reinsurance to the 1:100 event probable maximum loss (PML) level, using conservative assumptions in that calculation.

On an annual basis, private sector insurers purchase reinsurance to protect themselves from the potential financial impact of storms. The carriers incur this cost each year, whether or not storms occur. Refer to Attachment 7 for a comparison of the 2011 versus the 2012 storm season. Many of the carriers that we rate purchase reinsurance in excess of the 1:100 PML. Attachment 8 summarizes the 2011 and 2012 seasons.

## **What About Citizens Property Insurance Corporation?**

To reduce its premium charges, Citizens purchases markedly less reinsurance than private sector carriers. Although cost savings occur when the wind does not blow, the cost of catastrophes that have occurred are being financed by all Floridians through assessments added to their insurance premiums. These assessments are enumerated on the invoices Floridians receive from their insurers. Insurers recoup these charges by adding the cost to the premium that they charge. Insurers then remit the assessments to the State.

## **Observations**

1. Although Citizens, and its predecessor, the Florida Property Casualty Joint Underwriting Association, were initially to be the market of last resort, Citizens' recent growth has been fueled by its less than actuarially indicated rates. One would not expect consumers to forego a lower rate from Citizens to support a private sector response. If the market of last resort is inadequately priced, consumers will respond by purchasing its coverage.
2. Citizens' rate structure relies upon Floridians, not reinsurance, to pay claims related to a catastrophe.
3. Private sector insurers purchase reinsurance, including that mandated through the Florida Hurricane Catastrophe Fund, to pay claims related to a catastrophe.
4. In a marketplace where a stated goal is the reduction of the size of Citizens Property Insurance Corporation, we observe the Homeowners' premium volume of carriers reviewed and rated by Demotech grew about 12% from year-end 2010 versus 2011. In contrast, Citizens' homeowner's premium grew by nearly 36%, three times the growth rate of the entire market. This outcome is likely to be perplexing to those with a stated goal or objective of shrinking Citizens.



## **What About the Florida Hurricane Catastrophe Fund?**

The Florida Hurricane Catastrophe Fund (FHCF) was created in November 1993 during a special legislative session after Hurricane Andrew. The purpose of the FHCF is to protect and advance the state's interest in maintaining insurance capacity in Florida by providing reimbursements to insurers for a portion of their catastrophic hurricane losses. For the 2012 storm season, the FHCF has approximately \$17 billion in potential exposure and nearly \$9 billion in invested assets.

If a storm occurs and the FHCF experienced a shortfall because what it ultimately owes for reinsurance reimbursement is greater than its assets on hand, the FHCF would issue additional debt, above and beyond what it is amortizing at this point in time, to cover the shortfall. The additional debt would be amortized through assessments on assessable lines of business.

This mechanism for funding shortfalls has worked in the past. In the fiscal year report for the period ending June 30, 2011, the emergency assessment on assessable lines of business of 1.0% previously levied to finance the revenue bonds issued in 2006, 2008, and 2010 was increased to 1.3% on all policies written or renewed after January 1, 2011 until approximately 2016 when the debt will be paid off.

The debt incurred by the FHCF is amortized by the imposition of assessments on Floridians that purchase an insurance policy providing coverage for an assessable line of business. The assessment is collected by their respective insurance carriers and remitted to the State of Florida. In sum, to the extent that the FHCF has insufficient assets to respond to its reinsurance responsibilities, Floridians will be assessed to amortize funds borrowed by the FHCF.

Given the debt amortization mechanism in place has worked in the past in conjunction with annual statement reporting instructions prescribing or permitting all reinsurance recoverable due from mandatory pools should be reported as current, Demotech did not apply a haircut to carrier reinsurance reimbursement that might be due for the 2012 storm season.

## **Thoughts on Funding Catastrophe Losses**

Traditionally, insurers utilize predominantly private reinsurance to fund their catastrophe reinsurance protection. However, in Florida, reimbursement payment obligations of the FHCF, if the FHCF does not have sufficient funds on hand, are borrowed, with Floridians paying assessments on assessable lines of business to fund the principal and interest of the amount borrowed and then repaid over an extended period of time.

Private sector insurers are subjected to on-going regulatory as well as rating service scrutiny. Those insurers reviewed and rated by Demotech are subjected to at least four quarterly reviews each year plus a review of their catastrophe reinsurance coverage. When operating results are unacceptable or financial expectations are not met, capital must be infused to carry the insurer through the implementation time associated with recovery. The quality and quantity of catastrophe reinsurance is critically important to a regional carrier with exposure to potentially large loss events. At the current time, Demotech requires a 1:100 event as our minimum reinsurance level.



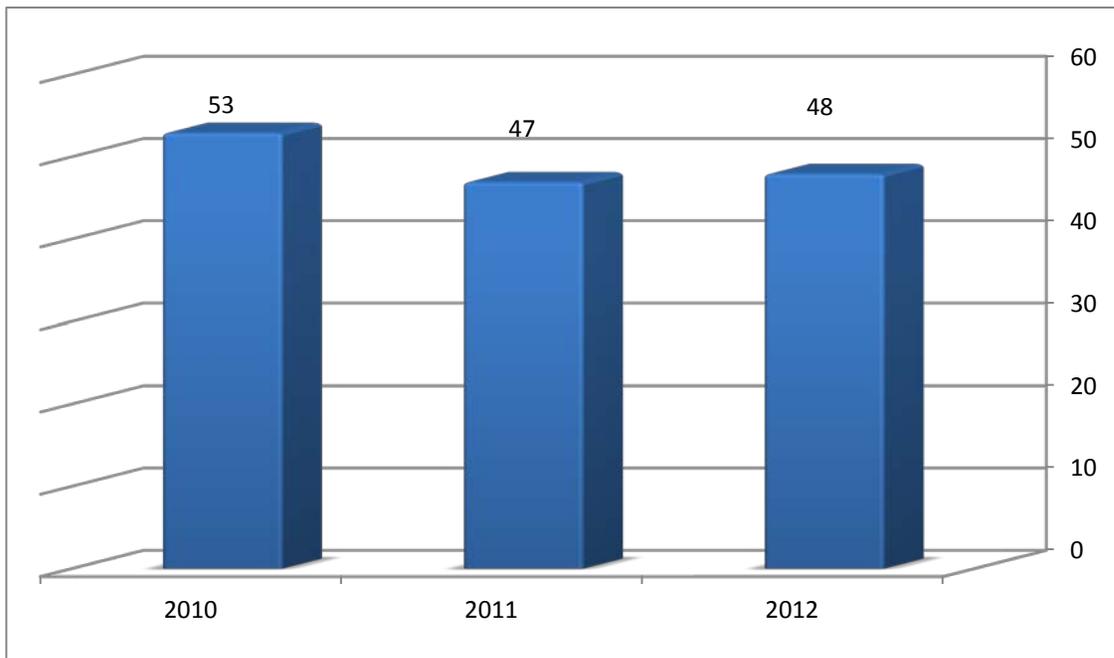
## **Concluding Comments**

Recent articles in the Florida media indicate that the depopulation of Citizens Property Insurance Corporation is a priority. If private sector insurers charge their insureds an actuarially sound premium, the insurers should be able to assist in this important endeavor, while concurrently being able to purchase an appropriate quantity and quality of catastrophe reinsurance. However, if Floridians remain interested in locating and identifying the insurer that charges them the lowest premium for their home, they may find that insurer is Citizens Property Insurance Corporation.

If one believes that economic reality and personal self-interest motivate consumers, the depopulation of Citizens may take longer than some believe or would like. In the interim, as we have done since 1996, Demotech will continue to evaluate current market conditions in Florida, the financial stability of reinsurers and private sector carriers specializing in Florida, the funding capacity of the Florida Hurricane Catastrophe Fund, the results emanating from the algorithms of catastrophe modeling companies and other factors that in our opinion impact the property insurance marketplace. This publication provides a brief summary of our activity in 2011 and 2012.

Company	DPW 2011	DPW 2010	% Change
Universal Property & Casualty Insurance Company	\$ 720,894,537	\$ 666,309,261	8.19%
St. Johns Insurance Company, Inc.	\$ 263,508,621	\$ 257,105,888	2.49%
American Coastal Insurance Company	\$ 233,348,559	\$ 203,696,468	14.56%
Southern-Owners Insurance Company	\$ 226,525,505	\$ 189,286,898	19.67%
American Strategic Insurance Corp.	\$ 221,281,094	\$ 175,393,629	26.16%
United Property & Casualty Insurance Company	\$ 202,061,413	\$ 157,869,548	27.99%
Security First Insurance Company	\$ 189,822,933	\$ 146,207,307	29.83%
Florida Peninsula Insurance Company	\$ 189,235,510	\$ 179,271,627	5.56%
Tower Hill Prime Insurance Company	\$ 157,836,157	\$ 141,783,450	11.32%
Southern Fidelity Insurance Company	\$ 154,709,153	\$ 129,662,756	19.32%
Castle Key Insurance Company	\$ 150,171,909	\$ 145,690,320	3.08%
Universal Insurance Company of North America	\$ 139,452,135	\$ 145,014,737	-3.84%
Tower Hill Preferred Insurance Company	\$ 137,734,088	\$ 133,659,816	3.05%
Tower Hill Signature Insurance Company (Formerly Royal Palm Insurance Company)	\$ 130,209,363	\$ 165,537,755	-21.34%
Homeowners Choice Property & Casualty Insurance Company	\$ 126,583,298	\$ 116,063,121	9.06%
ASI Assurance Corporation	\$ 125,709,336	\$ 128,772,088	-2.38%
American Integrity Insurance Company of Florida, Inc.	\$ 120,201,094	\$ 105,055,536	14.42%
Castle Key Indemnity Company	\$ 114,419,071	\$ 97,093,645	17.84%
Auto Club Insurance Company of Florida	\$ 108,839,692	\$ 68,773,915	58.26%
First Protective Insurance Company	\$ 107,451,580	\$ 96,205,405	11.69%
Florida Family Insurance Company	\$ 104,565,208	\$ 96,142,040	8.76%
Tower Hill Select Insurance Company	\$ 100,000,608	\$ 88,231,358	13.34%
Federated National Insurance Company	\$ 99,623,441	\$ 13,285,968	649.84%
Olympus Insurance Company	\$ 99,302,170	\$ 89,747,502	10.65%
ASI Preferred Insurance Corp.	\$ 96,566,022	\$ 71,699,126	34.68%
First Community Insurance Company	\$ 89,776,405	\$ 89,380,001	0.44%
Fidelity Fire & Casualty Company	\$ 85,397,618	\$ 69,796,826	22.35%
Sunshine State Insurance Company	\$ 84,823,172	\$ 114,673,125	-26.03%
Southern Oak Insurance Company	\$ 84,660,703	\$ 80,654,882	4.97%
Gulfstream Property and Casualty Insurance Company	\$ 84,233,111	\$ 72,776,683	15.74%
Cypress Property & Casualty Insurance Company	\$ 79,390,785	\$ 68,667,921	15.62%
Ark Royal Insurance Company	\$ 73,041,918	\$ 43,141,923	69.31%
Capitol Preferred Insurance Company	\$ 69,801,271	\$ 67,493,914	3.42%
Bankers Insurance Company	\$ 63,352,440	\$ 66,340,368	-4.50%
Nationwide Insurance Company of Florida	\$ 55,918,856	\$ 89,946,240	-37.83%
American Capital Assurance Corporation	\$ 55,512,359	\$ 53,105,795	4.53%
American Traditions Insurance Company	\$ 47,162,455	\$ 44,533,531	5.90%
Omega Insurance Company	\$ 45,487,771	\$ 39,651,890	14.72%
People's Trust Insurance Company	\$ 37,472,024	\$ 37,892,017	-1.11%
Safe Harbor Insurance Company	\$ 37,446,109	\$ 17,896,149	109.24%
Prepared Insurance Company	\$ 33,680,392	\$ 25,881,180	30.13%
Modern USA Insurance Company	\$ 33,374,866	\$ 30,321,696	10.07%
Safeway Property Insurance Company	\$ 28,523,515	\$ 27,929,890	2.13%
Sawgrass Mutual Insurance Company	\$ 27,310,535	\$ 14,374,430	89.99%
Avatar Property & Casualty Insurance Company	\$ 11,783,422	\$ 12,055,738	-2.26%
ACA Home Insurance Corporation	\$ 7,530,119	\$ 9,070,069	-16.98%
Lakeview Insurance Company	\$ -	\$ -	
<b>Sub-Total of Demotech Rated Companies in Florida</b>	<b>\$ 5,455,732,343</b>	<b>\$ 4,883,143,432</b>	<b>11.73%</b>
Citizens Property Insurance Corporation	\$ 1,567,340,653	\$ 1,156,647,315	35.5%
State Farm of Florida	\$ 895,209,289	\$ 1,048,819,694	-14.6%
Capacity Insurance Company	\$ 8,006,718	\$ 4,211,448	90.12%
Encompass Floridian Indemnity Company	\$ 1,972,990	\$ 2,686,587	-26.56%
Encompass Floridian Insurance Company	\$ 4,435,991	\$ 4,858,803	-8.70%
Homesite Insurance Company of FL	\$ 2,359,054	\$ 2,273,112	3.78%
<b>Sub-Total of non-rated Companies in Florida</b>	<b>\$ 2,479,324,695</b>	<b>\$ 2,219,496,959</b>	<b>11.71%</b>
<b>Sub-Total of Demotech Rated and non-rated Companies in Florida</b>	<b>\$ 7,935,057,038</b>	<b>\$ 7,102,640,391</b>	<b>11.72%</b>

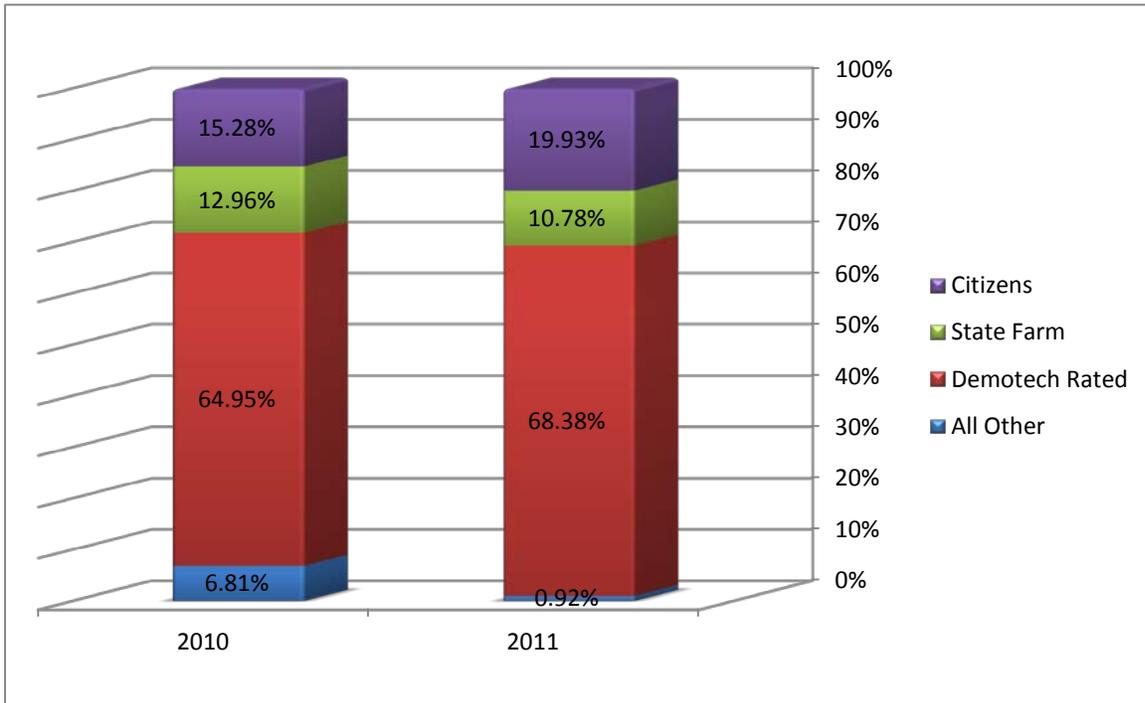
Number of Insurers Rated by Demotech, Inc. in Florida



\*2012 Data as as 7/31/12

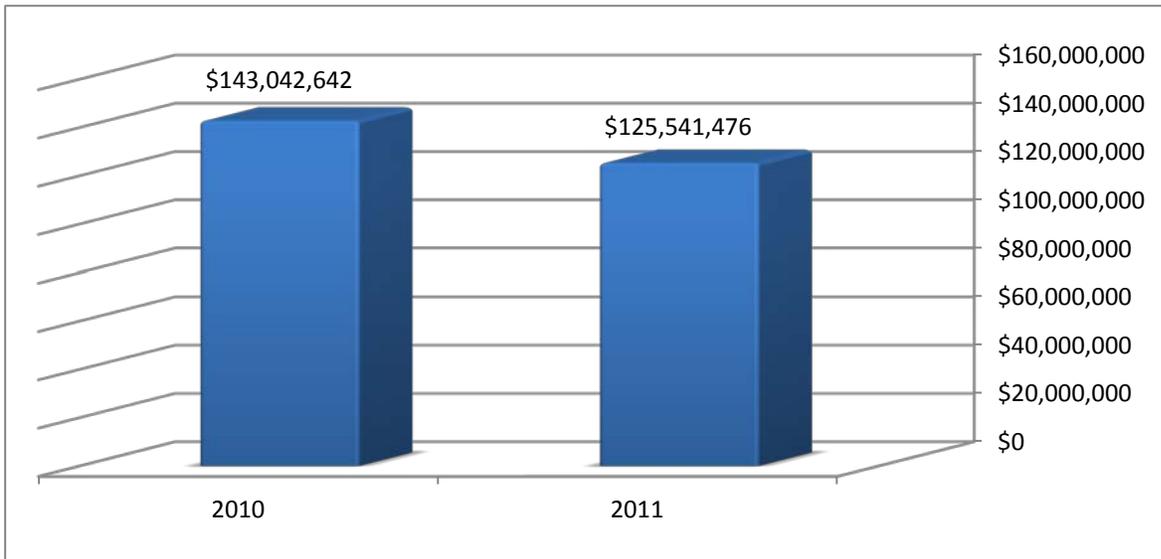
Attachment 2

Percentage of Florida Homeowners Direct Premium Written Reviewed by Demotech, Inc.



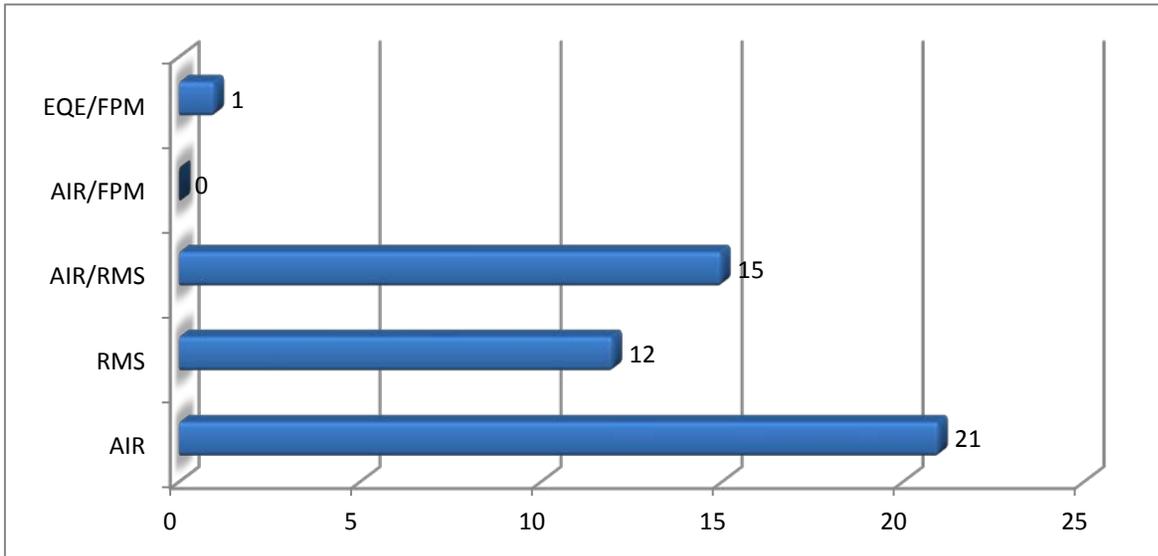
Attachment 3

Aggregate Capital Contributions Requested by Demotech, Inc.



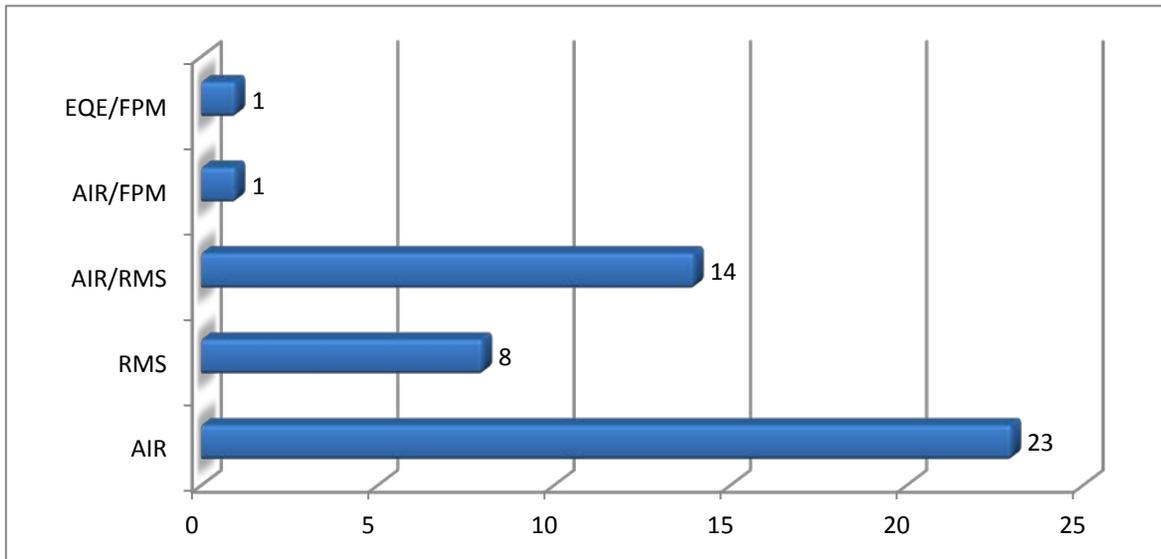
Attachment 4

### Catastrophe Models Utilized 2011



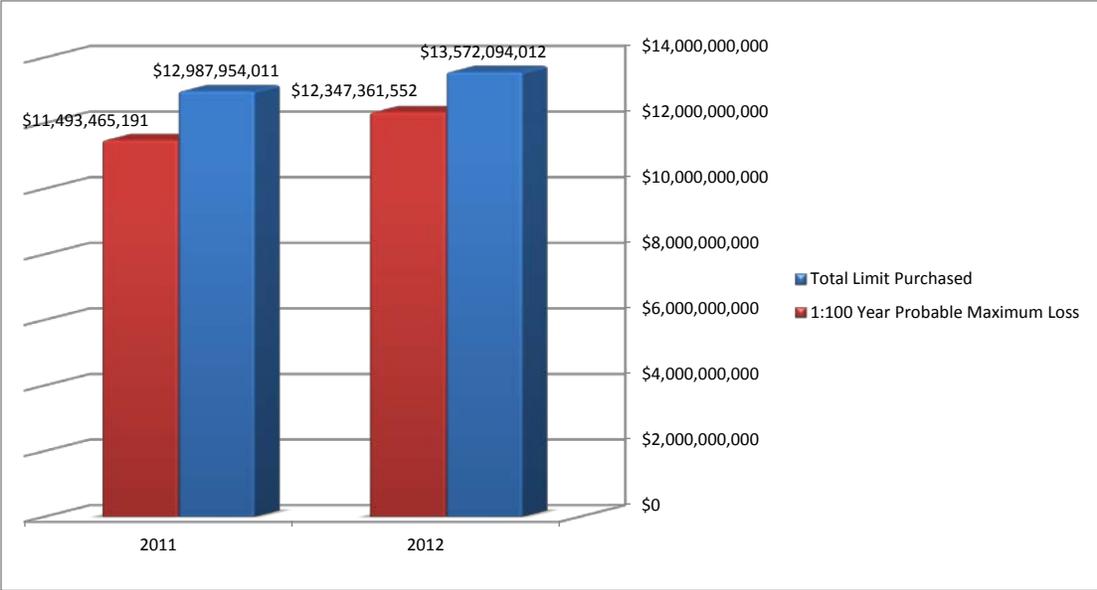
Attachment 5

### Catastrophe Models Utilized 2012

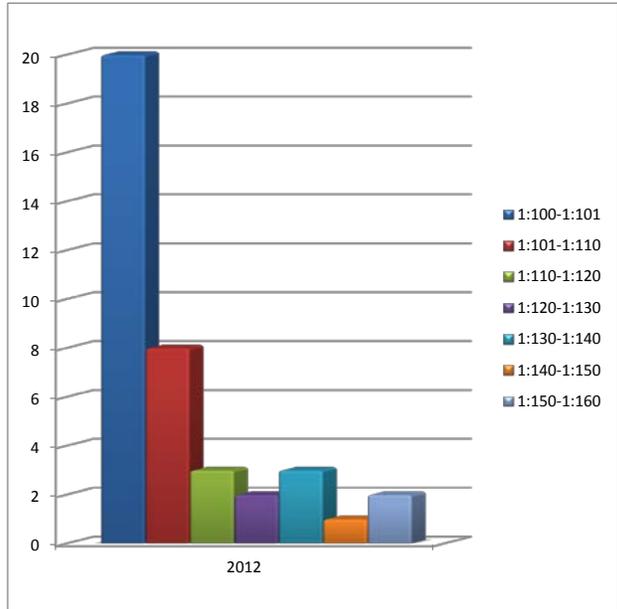
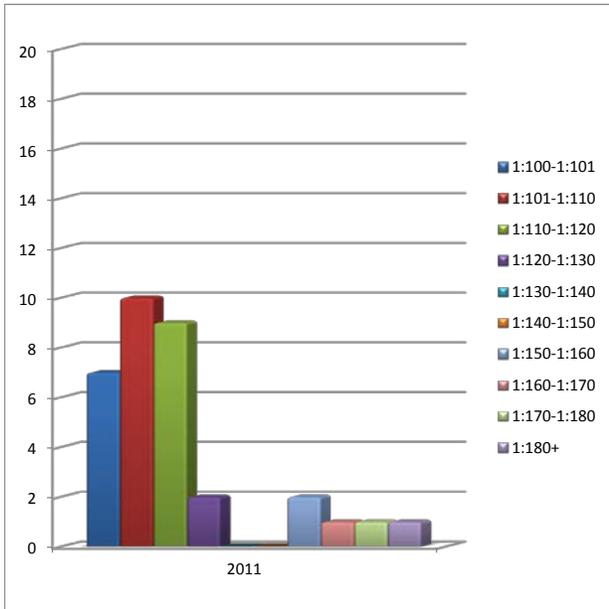


Attachment 6

Comparing Total Limit Purchased Versus 1:100 Year Probable Maximum Loss (PML)



Purchases to 1:100 PML or Greater - 2012 and 2011



Attachment 8