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George Grawe
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March 24, 2004

Lisa Miller
Office of Insurance Regulation
Larson Building
200 East Gaines Street
Tallahassee, Florida 32399-0330

Re: Profit and Contingency Factor Rule

Dear Mrs. Miller:

With this letter you will find a memorandum discussing Florida's current regulatory practice relative to permissible "profit and contingency factors" in the rate making process. This material was developed through a cooperative effort with Florida Farm Bureau. We hope that this is helpful and look forward to working with the Office of Insurance Regulation to benefit Florida's insurance consumers by increasing the availability of affordable homeowner coverage.

Sincerely,

George Grawe

Cc: Rade Musulin, Florida Farm Bureau

Regulatory Improvement for Florida Consumers

A Proposal to Benefit Consumers and Bring More Capacity to the Market

Introduction

Hurricane Andrew struck more than ten years ago, causing havoc for the people, businesses and economy of Florida. Andrew served as a brutal reminder that the business of insuring property in our state differs dramatically from other kinds of insurance business, and even differs dramatically from property insurance in other states. The differences between the economics of Florida property insurance and other kinds of insurance, together with regulatory policies that do not fully account for these differences, create a market environment that often works against the interests of consumers to have premiums that are as low as economically viable and discourages long-term market growth that can provide availability and affordability of coverage for all Florida property owners.

Unlike other lines of insurance, where average expected annual losses are relatively stable and predictable, the probable maximum loss (PML) for property insurers, due to hurricanes, can be far greater than average expected annual losses. A property insurer's average expected annual losses and hurricane PML must be funded, yet current regulatory practice assumes insurers need only enough capital to meet statutory premium to surplus ratio tests. These tests, which do not accurately reflect the capital structure of a modern property insurer, do not allow an insurer to fund hurricane PML[1].

This paper will describe how changes to current regulatory practices could improve conditions for Florida's property insurance consumers:

1. Rates may be favorably impacted
2. Insurers may be more willing to offer coverage, decreasing the number of risks in Citizens Property Insurance Corporation (Citizens)
3. Market may no longer skew towards thinly capitalized and highly reinsured firms.

By reforming rules governing how insurers calculate acceptable profit margins, the Florida Office of Insurance Regulation (OIR) could encourage well-capitalized insurers to risk their internal capital. This would reverse the adverse effects of the current system to the benefit of Florida's consumers. A firm's internal capital is almost always less expensive than rented capital (reinsurance) because a firm's internal capital is not subject to frictional costs associated with risk transfer.

Current Situation

Much has been done to encourage capital investment in Florida's voluntary property market since Hurricane Andrew. The Florida Hurricane Catastrophe Fund (FHCF) has been developed to provide insurers with low cost capital backed by assessment authority on Florida

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[1] The Office of Insurance Regulation requires an annual demonstration from each property insurer, of the insurer's plan to fund the 100-year PML. In addition, A. M. Best requires adequate capitalization and funding of PML in order to secure a rating acceptable to mortgage companies.

consumers. A uniform building code has been enacted by Florida's legislature that serves as an important step to lower PML enabling better alignment with capital resources. The Florida Property Joint Underwriting Association and the Wind Pool have evolved into Citizens, also backed by assessment authority. These systems have created a strong public/private partnership to fund the State's large PML. In spite of these efforts, Florida's PML has grown to unsustainable levels due to:

1. Substantial population growth
2. Exploding building costs
3. Increasing property values
4. Increased building and development in coastal areas

Proposed Solutions

Florida must take action to grow the capital base supporting its property insurance system by billions of dollars to keep up with growth. One critical component is the proposed enhancement of the FHCF. However, increasing the capacity of the FHCF requires that potential assessments on Florida's consumers be increased and exposes future generations to funding past losses, which places limits on how much the state can rely on this source of capital. Unless additional sources of capital are found, there will be no way to fund the State's increasing PML without ruinous rate increases, intolerable assessment burdens, or a halt to the development that fuels the State's economy.

Fortunately, there is a large source of capital readily available to meet this need: internally generated insurer surplus. Nationally, the insurance industry has a capital base of approximately $291 billion[2]. The majority of this surplus is controlled outside of the State, meaning that the State cannot force it to be committed. However, by reforming its regulatory practices, the State can provide the proper economic incentives to insurers to invest this capital in Florida.

Economic Barriers to Industry Capital

One consequence of Hurricane Andrew is that the traditional approach to rate regulation will, now and into the future, discourage the capital investment that the Florida insurance market needs. Insurance rates involve three critical factors: expected losses, expenses, and profit. Profit is needed to compensate investors who provide capital (surplus) to support insurance operations. Traditionally, insurance rates have included a 5% profit factor. This traditional profit factor was likely based on a simple rule of thumb that if an insurer writes at a 2:1 premium to surplus ratio and needs a 10% return on surplus, a profit factor of 5% of premium would be sufficient. Hurricane Andrew has shown us that rate regulation for property insurance must recognize that this "one size fits all" approach to the profit factor discourages private capital investment.

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[2] The total policyholders' surplus for the Property and Casualty industry, according to Best's Aggregates and Averages 2003 edition, is $290,904,810.

An example of how current property rate regulation discourages capital investment may be helpful. Consider Greenacre Insurance Company (Greenacre), which writes two lines of insurance in Florida, automobile and homeowners. In order to keep this example simple, we assume there are no expenses and ignore investment income (meaning premium equals expected loss plus profit). Greenacre's actuaries estimate that the average expected annual loss from each line of business is $1,000,000. At the assumed 2:1 surplus ratio, required capital based on expected annual losses is $500,000 for both auto and homeowners. Greenacre's shareholders require a 10% return on exposed capital. The automobile riskline's exposure is limited to the expected annual losses; however, the homeowner's riskline is also subject to catastrophic risk, quantified as PML of $10 million. This excess risk requires $9 million in capital excess of expected annual losses. At a 10% required "shareholder" return, it must compensate its investors $50,000 in Auto and $900,000 in Homeowners.

However, under Florida's presumed profit factor rule (Rule 4-170.003), Greenacre will only be able to "justify" a maximum 5% profit on the expected annual loss of $1,000,000 for each riskline. This amounts to a $50,000 profit for the auto riskline and a 10% rate of return on invested capital. Unfortunately, the 5% ceiling imposed on homeowner's profit calculated against the expected annual losses does not take into account the $9 million in excess capital funded by Greenacre to cover the $10 million PML. Therefore the restricted $50,000 in profit results in a 0.56% rate of return on the $9 million investment.

	Auto	Homeowners
Expected Annual Losses	$1,000,000	$1,000,000
Probable Maximum Loss	$0	$10,000,000
Maximum Loss	**$1,000,000**	**$10,000,000**
Required Annual Loss Capital	$500,000	$500,000
Excess Capital Requirements	$0	$8,500,000
Total Invested Capital	**$500,000**	**$9,000,000**
Maximum "Regulated" Return	$50,000	$50,000
Return on Capital	10.00%	0.56%
Required Shareholder Return	10.00%	10.00%
Gap	**0.00%**	**-9.44%**

Assumptions

- **Premium to Surplus Ratio:** 2 to 1
- **Required Shareholder Return:** 10%
- **PML:** $10 Million
- **Maximum "Regulated" Return:** 5% (Rule 4-170.003)

Why would rational investors expose $9 million to losses for $50,000 in compensation? For such risk, a savvy investor knows that far greater returns are possible in many alternative investments, including the "junk bond" market. Bonds provide an interesting contrast to Florida's property insurance market. When the risk of losing money on a given bond is higher, the yield on that bond must be higher, which is why Treasury bills have lower yields then so called "junk bonds". However, under current Florida property insurance rate regulation, the return allowed (presumed factor under Rule 4-170.003) is the same maximum 5%, regardless of the amount of risk.

Imagine a bond market where every bond had the same yield. Treasury bills and corporate bonds, with a higher probability of default, would yield the same rate of return.

Further imagine that the regulated yield was the Treasury bill rate. In time, there would be an availability crisis for bonds other than Treasuries needed to fund businesses with a higher probability of risk because investors would flee from that market.

The bond market offers another important analogy to our discussion. A critical consideration for investors is liquidity: can one get one's money out? In the bond market, investors can buy and sell their shares, and when the bond matures the investor's principal is returned. Consider what might happen if a bond investor bought a security with a one-year term where a regulator could force the investor to buy the security next year at a regulated interest rate and prevent the investor from taking the interest to use as the investor chose. Such a bond market would not have many investors, and interest rates would be much higher, if any investors could be found at all.

A key to attracting investor capital to Florida's insurance market is the investor's ability to remove that capital at the end of the investment term and to keep its interest to use as it pleases. Reinsurance allows this; the reinsurer issues a fixed-term contract at the end of which its capital is freed and the premium (interest) is kept. Investor provided insurance capital must be subject to the same type of liquidity. Efforts to require that capital be indefinitely tied up in Florida (such as through a non-renewal moratorium) or interest (profits) be held for a future hurricane, place investor capital at a disadvantage as compared with reinsurance and create a strong incentive for insurers to keep minimal investor capital in the state. This drives up rates, reduces availability, and leads to thinly capitalized insurers. It leads to a market where insurers can only generate capacity through retained Florida earnings, which guarantees market crises following every large hurricane as retained earnings are depleted and the supply of capital becomes extremely out of balance with demand.

Let us return to our Greenacre discussion. Greenacre's actuaries prepare a filing according to OIR rules and find a problem. Florida's OIR says it can only approve $1,050,000 in premium in every line (Greenacre would actually charge something like $1,030,000 in Homeowners and $997,000 in Auto, due to investment income). In Auto that premium would be adequate, but in Property it would be grossly inadequate.

One way Greenacre might deal with this is to notice that under Florida's rating law it can include "reinsurance costs" in its rates. The actuaries would recommend to management that it buy reinsurance for the $9 million in excess exposure (PML minus expected annual losses) as an alternative to holding capital. Since the reinsurers must make a return on capital exposed to loss and since they have expenses, excise taxes, and such, the market rate for reinsurance might be a 15% "rate on line", or $1,350,000. Thus, if Greenacre bought reinsurance to cover the exposure/PML, it could "justify" a premium of $2,350,000. Note that this is higher than the premium it would need to fund the loss through investor capital.

Greenacre management notices another problem with the actuaries' recommendation: until Greenacre actually buys the reinsurance, the regulator will not allow its cost to be included in rates. After it buys the reinsurance, it must lose money for a year or more until it can file for rates reflecting reinsurance costs, secure approval and implement over 12 months. One way around this would be to form a new insurance company that placed reinsurance before writing the business, which is what some investors have done in Florida. Alternatively,

Greenacre might simply take its investment capital to insurance markets where rates of return reflecting required capital can be expected.

Rule Change Could Significantly Benefit Consumers

The Greenacre example is simplistic but it demonstrates how current Florida property rate regulation can lead to higher rates for consumers and drive capital investment from the state. Major companies that do not buy reinsurance cannot "justify" actuarially sound rates, as the return allowed on internal (investor) capital does not properly reflect the risk. Thus, insurers are discouraged from bringing in new capital, and the market shifts to Citizens and to companies relying on reinsurance. Companies relying on reinsurance, under existing rate regulation, can "justify" rates to include such reinsurance costs. Generally, investor capital will be less expensive than reinsurance capital. If insurers could file and receive approval for a profit and contingency factor that properly reflects risk they could achieve a rate level that would justify investors providing capacity through capital, reducing the need for expensive reinsurance.

Property rate regulation could be modified to allow for the real differences in capitalization that exist with other lines of insurance. A possible solution could be the creation of a more economically viable formula and clear procedures to allow the "presumed factor", currently described in Rule 4-170.003, to be adjusted in recognition of rational "risk loads" associated with this vital segment of the insurance market. Florida Statute 627.062 allows for such "risk" in ratemaking and as such a legislative change does not appear necessary. The FHCF annually engages in an analysis relative to the standard deviation of annual hurricane losses in the calculation of FHCF premiums. It may be useful to study this process while considering whether the creation of a rational "risk load" formula/procedure seems an appropriate solution.

The Greenacre illustration also demonstrates the importance of the FHCF. Since FHCF uses post-event "assessment capital", it can avoid holding all the capital required to meet its obligations[3] and avoid charging any proper risk load. Further, the FHCF can provide AAL coverage with no risk load as the FHCF can levy assessments while the voluntary property market has no such assessment authority. As a result the voluntary property market must have a proper risk load in its rates in order to pre-fund such losses. FHCF rates are far below the reinsurance market because it charges premiums that reflect only loss costs discounted for investment income, which, except for the 5% "presumed factor" prescribed by Rule 4-170.003, is the manner in which the OIR currently regulates primary property insurer rates. FHCF rates approximate what the OIR is allowing in primary property rates, which is why expanding FHCF capacity is one necessary step to maintain balance in the market.

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[3] The FHCF currently has capacity to reimburse up to $11 billion of hurricane losses during a single season. At the end of last year, FHCF has only $5.5 billion in invested assets. The remaining $5.5 billion would be funded by post-event bond issues financed through assessments on all P&C insurers.

Conclusion

Florida's current regulatory practices in property insurance encourage insurers to rent (purchase of reinsurance) rather than own (investing insurer capital), and the resulting shortage of capital forces the State to borrow the difference and pass the bill along to future generations as assessments. This is completely opposite from government polices in other sectors of our economy designed to encourage ownership of assets. In housing, this is the equivalent of allowing consumers to deduct rent from their taxes but not mortgage interest.

Florida's regulatory practices need to be restructured to create a level playing field between reinsurance and investor supplied capital. This requires that risk loads be allowed as an alternative to the cost of reinsurance and that investor capital, and reasonable profits thereon, are afforded the same degree of liquidity as reinsurance capital. The actuarial profession offers Florida regulators tools that can address this situation. There are generally accepted methods for calculating "risk loads" on lines of insurance subject to catastrophic loss. Working toward incorporating these methodologies into its regulatory paradigm is a critical component of a strategy to build a strong property insurance system for the benefit of Florida's consumers. The current rule has the effect of giving reinsurers a significant financial advantage while sacrificing the interests of consumers because it requires consumers to pay higher premiums, limits the amount of capacity to support the market and discourages depopulation of Citizens.

We hope that this information is helpful, and we welcome the opportunity to work with the OIR in creating workable solutions for the benefit of consumers.