

# Florida Hurricane Catastrophe Fund



Annual Report of Aggregate Net Probable Maximum Losses,  
Financing Options, and Potential Assessments

February 2017

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*The data contained in this report has not been audited. This report was prepared by Raymond James & Associates as financial advisor to the Florida Hurricane Catastrophe Fund.*

# **Annual Report of Aggregate Net Probable Maximum Losses, Financing Options, and Potential Assessments**

## **Purpose and Scope**

Section 627.35191, Florida Statutes, enacted in 2013, requires the Florida Hurricane Catastrophe Fund (FHCF) to provide a report to the Legislature and the Financial Services Commission regarding the aggregate net probable maximum losses, financing options, and potential assessments of the FHCF. More specifically:

### **627.35191 Required Reports.—**

(1) By February 1 of each year, the Florida Hurricane Catastrophe Fund and Citizens Property Insurance Corporation shall each submit a report to the Legislature and the Financial Services Commission identifying their respective aggregate net probable maximum losses, financing options, and potential assessments. The report issued by the fund and the corporation must include their respective 50-year, 100-year, and 250-year probable maximum losses; analysis of all reasonable financing strategies for each such probable maximum loss, including the amount and term of debt instruments; specification of the percentage assessments that would be needed to support each of the financing strategies; and calculations of the aggregate assessment burden on Florida property and casualty policyholders for each of the probable maximum losses.

## **Introduction**

The FHCF plays a significant role in the provision of property insurance coverage for Florida residents. Eleven consecutive seasons with limited claims payment activity have given the FHCF an opportunity to accumulate sufficient reserves to prepare for future storms. The FHCF has significant financial resources as of the end of 2016, with an estimated fund balance of approximately \$13.8 billion. In addition to these resources, the FHCF also has \$2.7 billion available in pre-event bond proceeds from outstanding Series 2013A pre-event debt (\$1.5 billion outstanding) and Series 2016A pre-event debt (\$1.2 billion outstanding) providing additional liquidity for 2017 and subsequent seasons. Nonetheless, the FHCF might still need to rely on emergency assessments and/or post-event bonding to pay claims if a storm or storms of sufficient magnitude impacted Florida. The analyses presented in this report summarize those resources and how the FHCF would apply them after an event.

## Aggregate Net Probable Maximum Loss

The basic claims payment structure of the FHCF is as follows:

- Except for certain de minimis exemptions, all admitted insurers writing residential property insurance in Florida, including Citizens Property Insurance Corporation, are required by Section 215.555, Florida Statutes, to obtain FHCF reimbursement coverage.
- The FHCF reimburses each participating insurer for a portion of its hurricane losses under residential policies. The insurer has the option of selecting a coverage percentage of 45%, 75%, or 90%.
- An insurer's FHCF reimbursement coverage is triggered after it meets its retention (the functional equivalent of a deductible). For the contract year that began on June 1, 2016 and ends on May 31, 2017, the aggregate retention for all participating insurers is approximately \$7.0 billion. Aggregate retention for the contract year beginning on June 1, 2017 is projected to be approximately \$7.0 billion. Once an insurer's losses exceed its share of the aggregate industry retention, it triggers coverage. It is not a requirement that aggregate insurer losses exceed the aggregate industry retention prior to that insurer being eligible for FHCF reimbursement.
- The maximum obligation of the FHCF for a given contract year is specified by statute. The current maximum is \$17 billion. Each insurer's reimbursement coverage is limited to its share of the \$17 billion maximum obligation.
- An insurer's reimbursement premium, retention, and coverage limit are based on its total insured values by ZIP code as of June 30, which must be reported by each insurer annually by September 1 of each year.
- The claims-paying resources of the FHCF include:
  - Reimbursement premiums: cash available from current and past accumulation of reimbursement premiums and investment income. The cash balance is used before any of the other claims-paying resources are used. The FHCF collected approximately \$1.03 billion in reimbursement premium, net of expenses and debt service, from participating insurers for the 2016-2017 contract year and the total preliminary cash balance as of December 31, 2016 was \$13.8 billion. The FHCF is projected to collect over \$1.1 billion in reimbursement premium, net

of expenses and debt service, for the 2017-2018 contract year and the total projected cash balance as of December 31, 2017 is \$14.9 billion.

- Proceeds from pre-event financing: the FHCF currently has \$2.7 billion in pre-event bond proceeds consisting of \$1.5 billion of Series 2013A pre-event bonds and \$1.2 billion of Series 2016A pre-event bonds.
- Proceeds from any post-event debt: post-event debt is repaid from emergency assessments on most Florida property and casualty premiums of both admitted and non-admitted lines of business (the exceptions are workers' compensation, medical malpractice, accident and health, and federal flood insurance). Post-event resources could also include funds from assessments levied without the issuance of post-event debt. The maximum assessment percentage is 6% with respect to any one contract year's losses and 10% with respect to all contract years' losses combined. No such post-event debt is outstanding and therefore there are currently no assessments.
- Risk transfer: recoverables from reinsurance and other risk transfer products. The FHCF purchased \$1 billion of reinsurance for the first time ever for the 2015 season and again in the amount of \$1 billion for the 2016 season. No such risk transfer products are in place as of the date of this report for the 2017 season.

Table 1 on the following page shows the net probable maximum loss to the FHCF from storms of the return time specified. The loss calculations were derived from the FHCF 2016 Ratemaking Formula Report prepared by Paragon Strategic Solutions Inc., consulting actuary to the FHCF. The complete 2016 Ratemaking Formula Report can be found at <http://fhcf.paragonbenfield.com/pdf/16ratereport.pdf>

**Table 1**  
**(\$ in billions)**

Return Time (Years)	Gross Probable Maximum Loss <sup>1</sup>	Maximum Net Losses to FHCF <sup>2</sup>	Adjusted Net Losses to FHCF <sup>3</sup>	Projected Year-End Fund Balance <sup>4</sup>	Potential Post-Event Bonding <sup>5</sup>
250	\$69.52	\$17.00	\$16.86	\$14.94	\$1.92
100	47.05	17.00	15.64	14.94	0.70
50	31.45	16.69	12.72	12.72	N/A

Coverages	Amount
2017 Retention (Projected)	\$7.00
FHCF Coverage	\$17.00

<sup>1</sup> Represents gross loss to all Florida residential policyholders from a storm of the indicated return time multiplied by 1.05 to allow for 5% loss adjustment expenses pursuant to Section 215.555(4)(b)1, FL Statutes.

<sup>2</sup> Based on the maximum statutory limit and the assumption that the FHCF operates as a single industry entity with a single industry retention and industry limit that apply to industry gross losses from total industry exposure.

<sup>3</sup> Based on the assumption that the total FHCF net losses is the sum of losses from approximately 159 individual companies, each with its own retention, limit and exposure distribution. Under this assumption it is unlikely for all insurers to trigger or exhaust the total of all FHCF coverage. Adjusted loss information for 2017 is not available, and may be different from that shown as derived from the 2016 Ratemaking Formula Report.

<sup>4</sup> FHCF fund balance is projected as of 12/31/17. Due to the sufficient funds to cover the adjusted net loss in an event with a 50 year return time only the necessary funds of \$12.72 billion are included on the table resulting in zero potential for post-event bonding.

<sup>5</sup> Adjusted Net Losses to FHCF less Projected Year-End Fund Balance. Assumes the use of post-event financing, which is repaid with emergency assessments but does not contemplate any risk transfer for 2017.

Numbers may not add due to rounding.

## Financing Options

The FHCF undertakes two basic types of financing: (1) pre-event financing to provide liquid funds to reimburse participating insurers in a timely manner; and (2) post-event financing designed to provide the ultimate source of payment of covered claims in excess of cash on hand.

The FHCF has \$2.7 billion of pre-event debt outstanding consisting of \$1.5 billion of Series 2013A pre-event bonds and \$1.2 billion of Series 2016A pre-event bonds. The proceeds of these pre-event financings are available to pay future claims. Pre-event interest expenses are designed to be paid primarily from the interest earnings on the invested proceeds of the pre-event bonds (which are retained pending their use to pay future claims) and from reimbursement premiums. There are no assessments associated with

pre-event bonds of the FHCF. If the proceeds of pre-event bonds are ever used to pay claims, the FHCF can levy emergency assessments to pay back the pre-event bonds or the FHCF can refinance such pre-event bonds using post-event bond proceeds secured by emergency assessments.

The FHCF has no post-event bonds outstanding. The FHCF defeased its outstanding post-event bonds issued to pay claims for 2005 events and therefore the associated assessments were also eliminated for all policies issued or renewed on or after January 1, 2015.

The FHCF has the statutory authority to amortize its debt over a term of up to 30 years. Given the magnitude of the losses summarized in Table 1 above, the FHCF could use this full term (or any shorter term) for any bonds associated with the financing of these losses. The FHCF re-entered the market in February 2016 with the successful execution of the \$1.2 billion Series 2016A taxable pre-event financing, which was executed during a time of significant volatility in the market due to global factors. Market conditions are significantly better; however, access to the market can be uncertain yet critical to understanding the challenges facing the FHCF, especially after a large event. As summarized in Table 1, bonding needs of this size are normal by municipal market standards.

Conditions in the municipal and corporate markets are favorable, having significantly improved in recent years. U.S. corporate bond sales increased to over \$1.5 trillion in 2016, marginally surpassing the prior record in 2015, as investors sought higher-yielding alternatives to government securities and companies took advantage of relative all-time low interest rates. The corporate bond market has topped \$1 trillion each year since 2010 as interest rates have been consistently historically low. After declining significantly in 2013 and 2014, municipal issuance has also rebounded strongly. In 2016, the long-term municipal bond market was 15% higher than 2015 and 38% higher than 2014, with \$434 billion in total issuance, of which \$39 billion was taxable.

**Table 2**  
**(\$ in billions)**

Year	Municipal Issuance				Corporate Issuance	
	Tax-Exempt (\$B)	Taxable (\$B)	Total (\$B)	% Change from Prior Yr	Par (\$B)	% Change from Prior Yr
2011	\$247	\$31	\$278	-35%	\$1,045	-4%
2012	\$335	\$32	\$367	32%	\$1,387	33%
2013	\$277	\$35	\$312	-15%	\$1,420	2%
2014	\$292	\$23	\$315	1%	\$1,489	5%
2015	\$350	\$28	\$378	20%	\$1,513	2%
2016	\$395	\$39	\$434	15%	\$1,528	1%

*Source: SIFMA and Thomson Reuters.*

The FHCF has some additional factors working in its favor independent of strong fixed income market trends, including, but not limited to: (1) in February 2016, the FHCF re-established itself in the market with the successful pricing of \$1.2 billion of Series 2016A taxable pre-event bonds with 3 and 5-year maturities at a true interest cost of 2.52%; (2) the FHCF is a well-regarded, highly-rated credit (long-term ratings of AA/AA/Aa3 from Standard & Poor’s, Fitch, and Moody’s, respectively), closely associated with (though not guaranteed by) the State of Florida, which is a blue-chip name in the market; (3) similar to the outstanding pre-event financings, any post-event bond issuances of the size the FHCF may undertake would also be included in the various benchmark indices market observers use to track market performance, so institutional money managers seeking to at least match indexed returns may have a strong additional incentive to buy FHCF bonds, particularly if they are offered at interest rates marginally higher than those typically associated with AA rated credits; and (4) the FHCF has no post-event bonds outstanding.

Although financial market conditions have significantly improved since the financial crisis and are currently conducive to favorable debt issuance, it is not possible to guarantee future financial market conditions. If long-term bonding in sufficient amounts is not immediately available, the FHCF may need to explore alternatives, including the levying of emergency assessments with no financing, issuing bonds in multiple tranches over time and/or interim financing alternatives. The FHCF statute provides that the FHCF’s liability is limited to the amount it can actually raise from bonding and other available claims payment sources. The timing of reimbursements to insurers can vary depending on whether insurers need to pay their policyholders quickly, such as might occur with a category five hurricane causing a large number of total losses, or slowly due to a covered hurricane where large losses are due to many partial losses materializing over a number of years.

## Assessment Impact

As described above, in situations involving large losses with rapid loss development the FHCF would probably attempt a financing based on the projected or actual dollar losses generated by the hurricane or hurricanes in order to finance its statutory limit, as shown in Table 1. These bonds would be repaid using emergency assessments.

Table 3 shows the estimated annual assessment impact from the varying hurricane loss scenarios.

**Table 3**  
**(\$ in millions)**

Return Time (Years)	Potential Post-Event Bonding	Required Annual Assessment <sup>1</sup>	Required Annual Assessment (%) <sup>2</sup>
250	\$1,919	\$125	0.30%
100	705	46	0.11%
50	N/A	N/A	0.00%

<sup>1</sup> Assumes annual assessment for 30 years using an interest rate of 5%. There is no certainty that FHCF covered loss reimbursements can be financed at assumed interest rates. The amount which can be financed after an event could be financed over a shorter period of time or could be smaller and is subject to financial market conditions following the event.

<sup>2</sup> Assumes annual assessment base of \$41.5 billion, which was the base for 2015. If this base is smaller or larger, required assessment percentages would be marginally higher or lower than shown above.

## Conclusion

As a result of eleven consecutive years with limited hurricane losses, the FHCF is in its best financial condition ever and with a projected fund balance for the 2017 season of \$14.94 billion, or approximately 88% of its maximum statutory limit of \$17 billion. The FHCF's total liquid resources will be \$17.64 billion, or approximately \$640 million above its maximum statutory limit of \$17 billion, which includes the projected fund balance of \$14.94 billion and \$2.70 billion of pre-event bonds outstanding for the 2017 season. The strong financial condition of the FHCF helps to bolster the Florida economy and reduces the potential assessment burden on Florida policyholders.

For catastrophic events requiring funds beyond cash and pre-event bond proceeds, the FHCF relies on post-event bonding and other revenue sources for claims paying capacity. For catastrophic losses, either from an extreme single event or from multiple events, the FHCF will likely issue post-event bonds to pay claims and assess to repay the bonds. The potential assessment burden is estimated to be near zero for the 2017 season. In the event

bonding is required, conditions in the financial markets have also significantly improved over recent years. In addition, the FHCF can and may execute one or more post-event financings over a 12 month period in order to accommodate participating insurers' large losses that experience rapid loss development and exhaust their FHCF payout limits.

The ability of the FHCF to pay claims in a sufficient and timely manner is critical to the health of the Florida insurance market, property owners and residents, and the Florida economy in general.