John Rollins, Actuary, Milliman, and former Chief Risk Officer for Citizens Property Insurance Corp.

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Can California learn from Florida's experience in stabilizing the residential insurance market?

Over 25 years ago, in the wake of Hurricane Andrew, Florida faced an acute availability and affordability crisis in homeowners insurance. An abrupt rise in insurers' cost of capital after the unexpected and severe storm losses broke the connection between the property hazard risk faced by consumers and the insurers and reinsurers who commit capital to share that risk. Florida had an existing guaranty fund to deal with the dozen insolvent insurers, but responded to the state's future needs by chartering a trio of institutions: a state-backed scientific body to assess hazard risk (the Florida Commission on Hurricane Loss Projection Methodology or "Commission"), a state-backed reinsurer (the Florida Hurricane Catastrophe Fund or "Cat Fund"), and a state-backed direct insurer (now known as Citizens Property Insurance Corporation, or "Citizens"). Each institution plays a unique role in market stabilization.

- Recognizing that scientific catastrophe simulation models are essential in managing and measuring Florida hurricane risk, the Commission affirms that the models underlying insurance rates are accepted by experts as accurate and reliable.
- Recognizing that insurer solvency is dependent on the prudent use of reinsurance, but that market forces could cause large swings in reinsurance costs, the Cat Fund helps ensure reinsurance availability and affordability.
- Recognizing that the availability and affordability of residential property insurance is also dependent upon market forces, Citizens provides a market of last resort for Floridians.

Since Andrew, the state also encouraged fortification of both new and existing homes through a number of mechanisms which have resulted in reduced losses and lower premiums to millions of Florida homeowners. I will briefly discuss the salient features of each of these four initiatives, and how they are connected.

Hurricanes are infrequent yet severe events, and the losses they cause depend in part on building codes, home locations, and mitigation features, all of which change over time. Historical experience is thus insufficient to set rates. Instead, insurers use catastrophe models embedded with the latest science to reflect the range of potential storm outcomes under current conditions. <u>Insurers may use only models accepted by the Commission in Florida rate filings</u>.[1] The Commission is a body of a dozen experts, funded by the state, most selected by Florida's Governor and Chief Financial Officer[2]. It publicly reviews both private hurricane models and a publicly-funded Florida hurricane model every other year. Models

[1] F.S. 627.0628(3)(d).

[2] Some members are ex-officio, such as a regulatory actuary and the state's Insurance Consumer Advocate.

must meet over three dozen rigorous standards regarding meteorology, engineering, statistics, actuarial science, and computing. Other states' regulators often refer to its results.

Insurance companies buy backup protection from reinsurers because catastrophic event losses could exceed available capital and threaten the ability to keep promises to policyholders. Reinsurance costs are unregulated and vary with the risk of the insurer's book of business, but also with global supply and demand for capital. Florida law allows insurers to pass reinsurance costs to policyholders within insurance rates, subject to limitations and regulatory review. The Cat Fund offers a contract to reimburse insurers for hurricane losses only, excess of a per-storm retention, up to a fixed annual aggregate amount, at rates calculated by its actuaries after their review of the Commission-accepted models. The retention and payout are set by a formula in law, and the contract and rates are approved by the state[3] each year. The rates cover the Cat Fund's expected annual costs, plus a 25% loading to help it build cash. Cat Fund participation is mandatory for both Citizens and all private property insurers, but private insurers can select a co-payment level of 10%, 25%, or 55%[4]. In the past few years, the Cat Fund has itself bought private reinsurance and passed through the costs in its rates, and it can also borrow pre-event to ensure liquidity.

The Cat Fund ensures reinsurance is available for part of the hurricane risk of insurers[5] at a relatively stable cost, but its promised payout could exceed its own cash and reinsurance. In this deficit case, it would borrow post-event and service the debt by levying "emergency assessments" on nearly all Florida insurance policies[6] of up to 10% of annual premium for as long as it takes to retire the debt.[7]

At times of accelerating claims costs, high reinsurance prices, or underwriting restrictions, insurance for some types of properties, such as coastal and older homes, becomes insufficiently available, affordable, or both. Citizens was formed as a stable source of coverage, and is governed by a Board of nine volunteers appointed by the Governor, CFO, and Legislature[8]. It is regulated under the Florida Insurance Code and a law containing specific requirements for Citizens.[9] The keys to its role and ability to co-exist without crowding out a vibrant private market can be summarized as CARES – Coverage, Acceptance, Rates, Education, and Solvency.

- First, Citizens coverage must be "comparable" to private insurers, but the Board has broad authority to adjust coverage, contingent on regulatory approval, so that it is not overly generous.
- Second, Citizens offers policies direct to consumers, but only accepts a new policyholder after agents apply using a "clearinghouse" comparison-shopping platform. Only when no private

[3] The "State Board of Administration" that approves Cat Fund activities consists of the Governor, CFO, and Attorney General.
[4] Citizens must select 10% by law.
[5] Current risk estimates show that about one-third of all Florida hurricane reinsurance is provided by Cat Fund.
[6] Workers Comp, medical malpractice, accident and health, and federal flood lines are exempt from assessment.
[7] After 2005, the Fund levied an assessment that began in 2006 and was retired in 2015.
[8] The Governor chooses three, the CFO two, the House Speaker two, the Senate President two. The CFO chooses a Chair who supervises the CEO.
[9] Citizens has evolved over time, resulting from a combination of a legacy wind-only risk pool and two multi-peril risk pool similar to a FAIR plans, in 2002 and 2007. The enabling law for Citizens is F.S. 627.351(6).

insurer offers comparable coverage at an approved premium within 15% of Citizens is the policy accepted.[10]

- Third, Citizens' rates are proposed by its Board annually, and publicly reviewed by regulators under all rating laws and rules, plus the Citizens-specific law which limits rate increases for any single policyholder to +10% per year.[11] Citizens, like private insurers, passes through the cost of reinsurance and catastrophe bonds to policyholders in rates.
- Fourth, Citizens commits resources to ensuring Floridians know when Citizens is an option, what coverage is provided, how to report claims, and importantly, that their policies may be subject to higher assessments than those of private insurers after a storm.
- Finally, Citizens funds its obligations by building surplus during storm-free and favorable years, and maintaining a robust reinsurance program using three sources of capital: the Cat Fund, private traditional reinsurance, and private catastrophe bonds. Like the Cat Fund, if an annual deficit occurs due to storm losses exceeding cash and reinsurance, it can assess nearly all Florida insurance policies up to 10% annually for as long as it takes to cure it, though Citizens policyholders pay a one-time surcharge of up to 15% before others are assessed.[12]

All of these institutions have been influenced by the steady improvement in Florida building codes and emphasis on loss mitigation. Since the seminal adoption of a South Florida Building Code in 1994, a statewide building code in 2002, a state-funded mitigation grant program in 2006, and expanded insurance discounts for mitigation features in 2007, the models accepted by the Commission and the rates charged by the Cat Fund and Citizens have increasingly differentiated well-built and protected homes from others. By Florida law, private insurers must also provide significant discounts on windstorm premiums to more resilient homes[13]. Consumers have responded to risk signals, and recent hurricanes have shown the impact of this effort in reducing damage.[14]

Florida faces the central challenges of balancing the respective needs of property owners, insurers, and taxpayers, using the latest science to measure risk while ensuring transparency, and ensuring that insurance rates reflect scientific cost estimates that encourage mitigation and properly signal risk to consumers while keeping the cost of living affordable. The Commission, Cat Fund, and Citizens are instruments of meeting those challenges. Milliman has done a great deal of work in Florida and other states, and we stand ready to help California understand our experiences if there is any way we can help.

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[10] Upon renewal, the same platform is used to nonrenew any policyholder who is offered private coverage at a premium lower than Citizens.

[11] This provision is universally known in Florida as the "glide path", and is adjusted for any coverage changes and does not consider surcharges and any outstanding assessments from prior storms.

[12] Assessments apply in three tiers – first a one-time Citizens Policyholder Surcharge of up to 15% of annual premium, second a "regular assessment" of private insurance policyholders of up to 2% of annual premium, finally the emergency assessment of up to 10% annually. The "emergency assessment base" of premiums subject to assessments for Citizens and the Cat Fund are nearly identical.

[13] F.S. 627.0629.

[14] An example is discussed in https://www.air-worldwide.com/Blog/How-the-Sand-Palace-Survived-Hurricane-Michael/