

Capital and finance: Alligators don't pay taxes

The Florida Hurricane Catastrophe Fund (FHCF) has just issued a \$693m bond to pay losses from the 2005 (Katrina, Rita, Wilma) hurricane season. The FHCF is a fascinating vehicle. It is ultimately a political entity used to drive down the price of homeowners insurance in Florida, but it also drives much more than that – including the pricing in a variety of markets.

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The politics of hot air

Florida hurricane is the driving risk in the property catastrophe markets. One of the underwriters most admired by the BRAVE partners summed up the market well: “When building a property cat portfolio, you decide how much Florida wind you can bear, then you fill in the rest with some diversifiers”.

As Florida is hit so regularly by large storms (4 out of the top 10 insured losses in history are hurricanes that passed through Florida – counting Katrina which glanced across the bottom at below hurricane wind speeds), the cost of reinsurance is high. This drives the cost of insurance high. The insurance prices are limited by the regulator because the primary carriers need regulatory approval to increase their prices, so the market often gets squeezed and the major carriers invariably withdraw. As the major carriers withdraw, a major demand-supply imbalance emerges which has the source of an investment play through small start-up “depop” Florida insurers for many years.

The cat fund

The State of Florida also established its own reinsurer in order to drive down the cost of reinsurance. This reinsurer is called the Florida Hurricane Catastrophe Fund, or FHCF. The idea is that this is a not-for-profit reinsurer that funds losses as they occur. Since this reinsurer does not require capital and does not seek to make a risk driven return on that capital it can price the risk close to the long term average.

Whilst the FHCF seems like a reasonable plan, the issue is that it still costs to have substantial reserves sitting around in cash, so the FHCF does not carry funds to cover anything like the total exposure that it has to hurricanes. The fund is unfunded.

Collecting for stray cats

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Promise to pay

Florida state insurance statutes require insurers to purchase cover from the FHCF. This premium income is an important part of the funding mechanism. However, in a bad year the premiums collected can easily be wiped out by claims. At this point any unfunded exposure must be funded. The funding mechanism is for the FHCF to issue revenue bonds against various tax raising powers that it has.

Alligators don't pay taxes

The revenue bonds that the FHCF issues are backed by a tax levy on all insurance premiums within the State of Florida. Assessing the credit risk of the FHCF therefore amounts to: finding the insurance premium volume for the State, deriving the cashflow that the allowable tax levy produces and assessing whether that will repay the bond. Well - not quite!



“Alligators don't pay taxes.”

Two other factors enter the equations. Firstly – will there be sufficient market appetite for all the bond that needs to be issued. Under certain scenarios this could be as high as \$30bn+. This is a lot of revenue bond to be issued.

However, possibly the most important issue is whether or not the tax revenues will hold up post a large event. The type of hurricane, or hurricanes, that would cause a \$30bn loss to the FHCF would be absolutely devastating to a large, densely populated area. It is the strong, large category 5 ploughing through South Beach and downtown Miami and driving in a large storm surge scenario. As we have seen from Hurricane Katrina, the population and population dynamic post-event is very different to pre-event. Just compare the before and after Katrina 'photos for large sections of New Orleans.

People need to stay in the State of Florida to pay insurance premiums in Florida. Katrina showed us that large catastrophes displace people. Moreover, you are not going to insure your car when it is already floating in the Atlantic. If all the people leave, returning Florida to a population of alligators, then the State will discover that alligators don't pay taxes.

FHCF risk

This funding risk for the FHCF is not insignificant. A.M. Best effectively rate the FHCF as well below investment grade. This is because they apply a substantial capital charge factor to this exposure which would be consistent with a well below investment grade reinsurer. The issue of concern is whether or not the FHCF can really raise the funds to pay claims after a really big event; exactly the time that the insurers will be suffering and really need their reinsurer to pay. The FHCF coverage only pays to the extent that funds are available. The contracts explicitly pro-rata down payments if the funds of the fund fall short of the total claim.

Opportunistic

So, why the recent bond issues from the FHCF? The news item on Bloomberg suggests that this is for claims arising from the 2005 season. This would seem a little strange. Property catastrophe reinsurance

is largely known and settled within three years of an event. We are now getting to five years from the 2005 hurricane season, so this does not seem to fit.

Sell revenue bonds while the wind doesn't blow

At BRAVE Partners, we suspect that the FHCF is actually taking a market opportunity to pre-finance any potential claims for the 2010 season. The municipal bond market has been in turmoil through the credit crisis. With the 2010 hurricane season set to officially start on June 1 and predicted to be more active than average, the FHCF needs to get ready. With credit markets jittery, the chances of funding post a major event are slim, so it makes sense to pre-fund. The statutes and rules around the FHCF might not really allow for this, so it can be constructed and billed as replenishment from 2005. The fund certainly paid out for that year.

Alligators don't pay taxes, so it is prudent for the FHCF to fund while it can.

- The Florida Hurricane Catastrophe Fund (FHCF) is a fact of life for insurers and reinsurers in the Florida market.
- The FHCF generates both risks and opportunities.
- BRAVE Partners has the skills and experience to guide those exposed to the FHCF through a variety of channels and mechanisms.

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BRAVE Partners services

BRAVE Partners has considerable experience and expertise in the market for Florida wind risk.

The partners have previously funded depop business and structured credit protection and liquidity facilities for the FHCF.

BRAVE Partners can assist in strategies for businesses that seek to invest in Florida wind risk, or can advise on risk mitigation techniques for those exposed either directly to Florida wind risk, or those indirectly exposed through an FHCF, or similar, exposure.

Interaction

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