

Catastrophe bonds

Legislative reform in Florida and its consequences for policyholders, the insurance industry and the CAT Bond market

Florida passes property insurance law reform

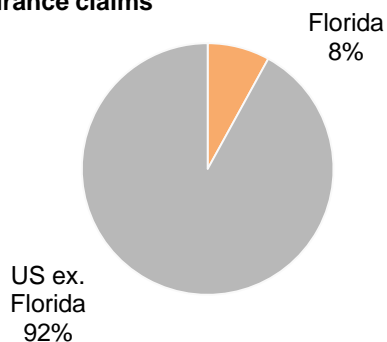
Dirk Schmelzer, Managing Partner, Senior Portfolio Manager

- The property insurance reform bill signed into law on 14 December is historic and will allow insurers to significantly reduce litigation costs associated with settling property claims following a hurricane in the state of Florida
- We do not expect immediate relief for insured households. On the contrary, Florida residents already pay an average of USD 4,200 per year for property insurance and this will increase in the short term.
- If new capital can be attracted to the Florida insurance market in the medium term, competition among private insurers will increase again, which may subsequently lead to lower insurance rates for homeowners
- We expect this bill to make the Florida CAT Bond market more dynamic and diverse thanks to new market entrants. This will provide CAT Bond investors with a broader choice of investments in the future. Even before the legislative reform, the CAT Bond market was very attractive with premium levels at a 20-year high. Combined with the improvements as a result of the legislative reform, this market will become even more attractive

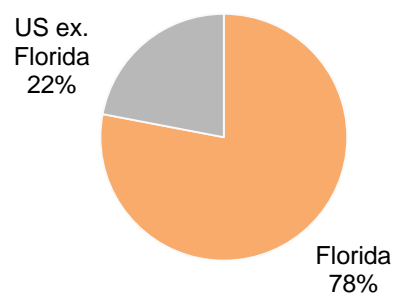
Long tradition of litigation in the settlement of claims

Florida is by far the largest natural catastrophe market in the world and is characterised by recurrent litigation and fraud in the settlement of claims. This leads to high insurance premiums for the insured, but also high costs for reinsurance coverage. Two figures clearly illustrate the problem: insurance claims in Florida account for 8% of all US insurance claims, yet the state of Florida accounts for 76% of all litigation costs from insurance claims. This is according to data from the Florida Office of Insurance Regulation.¹ This cost share was passed on to the insurance companies and resulted in claims costs that far exceeded the actual property damage incurred.

Insurance claims



Costs for legal disputes



¹ <https://www.insurancejournal.com/news/southeast/2021/04/14/609721.htm>

This issue became particularly apparent after Hurricane Irma in 2017. The final claims costs were in some cases very far above the insurers' initial estimates. With this experience, reinsurers and ILS investors demanded higher premiums and hence reinsurance premiums reached a level that forced some weaker-capitalised insurance companies to go out of business without a major loss event having occurred before. The following facts illustrate the problem of the insurance market in Florida:

- Six Florida insurers became insolvent in 2022 and had to give up their Florida business
- 27 insurers were at risk of a rating downgrade in August 2022
- The rating agency AM Best notes that the five largest insurers in the USA have a combined market share of over 50% on average for all states excluding Florida. In Florida, their market share is only around 15%
- Large reinsurers recently reduced their capacity for Florida by up to 80%²

In order to restore the confidence of the reinsurance and capital markets in the state's non-life insurance industry, reforms have been called for years to steer the market back in a positive direction.

Long overdue reforms

On 14 December 2022, Governor Ron DeSantis signed the SB 2-A property insurance reform bill into law. This bill, which has been demanded by Florida insurers for more than five years, is of historic importance and will make it possible to significantly reduce the litigation costs associated with the settlement of property claims following a hurricane. The reduction in claim settlement costs will be achieved by (1) the elimination of one way attorney's fees, (2) the elimination of the Assignment of Benefits (AOB), and (3) the reduction of the time period within which a new insurance claim can be filed from 3 years to 12 months. Given that fraud and litigation are rampant problems in Florida, these were three of the most important measures to ensure the continued functioning of the insurance market in Florida and to ensure that policyholders have access to more financially viable insurance coverage.

One way attorney's fees and assignment of benefits

In the past, property insurers were obliged to cover the legal fees of policyholders if they were able to successfully sue for their claims. From the insurers' point of view, this arrangement was an incentive for litigation and driving up costs - the figures below seem to support this view. With the de facto abolition of one way attorney fees, the financial risk for claimants increases, which should make suing for unjustified claims much less attractive.

² <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/fate-of-fla-property-insurance-market-at-stake-as-special-session-looms-70374127>

Year	Percent of Nationwide Homeowners' Claims Opened in Florida	Percent of Nationwide Homeowners' Suits Opened in Florida
2016	7.75%	64.43%
2017	16.46%	68.07%
2018	11.85%	79.91%
2019	8.06%	76.45%

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The controversial practice known as "Assignment Of Benefits for property insurance claims" ("AOB"), is also largely abolished by the new legislation. Under AOB, policyholders transfer their claims to contractors who then file a claim instead of the policyholders, decide about repairs and collect claims payments directly from the insurance company. Under AOB, the situation may be exploited to inflate repairs and costs or to charge for work that was never completed. This often resulted in lawsuits when insurance companies did not pay the costs in full or at all. These lawsuits have become problematic with Florida particularly affected:

- In 2018, there were 135,000 AOB claims, an increase of 70% in 15 years⁴
- According to Florida Citizens, between 50% to 70% of premium income is spent on legal costs
- In total, the FBI estimates that nearly \$6 billion of the \$80 billion allocated for Hurricane Katrina recovery was due to fraudulent claims⁵

Insurer of last resort "Florida Citizens"

In addition, the law addresses the shift in the market from private insurers to Florida Citizens, a state-supported insurer that offers coverage at favourable conditions to policyholders who cannot find coverage on the private market. Originally conceived as a backstop solution for policyholders, the insurance company had recently doubled in the number of policyholders to now 1.15 million policies. In future, policyholders who receive an offer from a private insurer that costs less than a 20 percent surcharge on the Citizens premiums will have to switch to private insurance. The aim is to ensure that policyholders find financially sound options in the private market. However, this requires risk-adjusted pricing of insurance premiums in a market that already has very high costs for insurance.

³ <https://www.insurancejournal.com/news/southeast/2021/04/14/609721.htm>

⁴ <https://www.insurancebusinessmag.com/us/news/breaking-news/aob-abuse-in-florida-rises-70-in-15-years-163448.aspx>

⁵ <https://www.fbi.gov/stats-services/publications/insurance-fraud>

No falling premiums in the short term

Even though the amendment of the law is not applicable to the settlement of claims due to Hurricane "Ian", the reforms now underway will have a considerable impact on the development of the insurance market in Florida. However, immediate relief for insured households is not to be expected.

- Today, Florida residents pay an average of USD 4,200 per year for property insurance (!), which is about three times the US average
- According to the Insurance Information Institute, premiums are currently rising by about 33% per year (!), a multiple of the average premium increase for US citizens of 9%⁶
- The immense cost result in a high rate of uninsured homeowners. In Florida this rate is 12% despite the high hurricane risk compared to the national average of 5%

The newly introduced obligation for Florida Citizens policyholders to take out additional flood insurance will make coverage more expensive for homeowners. They will be obliged to switch to a private insurer if the surcharge on the Citizens premium is less than 20%. For many insured persons, the premium burden will therefore increase for the time being!

Barry Gilway, President, CEO and Managing Director of Citizens commented: "This is the beginning of a big change in the Florida property insurance market. It will draw capital back into the Florida market. It won't happen overnight, but it will happen much sooner than many think."⁷ The legislative reform should significantly reduce the costs associated with claims handling, leading to an increase in the profitability of the insurance business, as well as reducing uncertainties about the final claim amount after an event. This will make the market more profitable.

If this approach succeeds and attracts new capital, competition between private insurers will increase again, which will subsequently lead to lower insurance rates for homeowners.

Reassessment of Florida reinsurance risks

In the reinsurance industry and the Insurance-Linked Securities ILS market, the consequences of the recent legislative reform will lead to a reassessment of Florida risks. Hurricane risks in Florida are already one of the largest risks assumed by the industry today and tie up a lot of capital due to the risk concentration. However, the underlying risk profile and the uncertainty regarding the development of losses after an event are likely to have been reduced by the reform. In combination with the marked increase in reinsurance premiums in recent years, reinsurance risks in Florida have become much more attractive.

Reinsurers and ILS investors are still cautious about taking on more Florida risks, not least because risk premiums have also risen significantly outside Florida. In the medium term and subject to further major loss events, capital inflows and thus increasing competition can also be expected again on the reinsurance side. As in the primary insurance sector, this development is not expected to begin immediately. Reinsurers and ILS investors need to ensure that the legislative adjustment adopted is effective and that the premium level achieved is sufficient to cover claims costs - also in view of the consequences of climate change - capital costs, expenses and an adequate profit margin before expanding exposure in Florida.

⁶ <https://eu.usatoday.com/story/news/politics/2022/12/12/florida-legislature-opens-special-session-on-property-insurance-homeowners/69713552007/>

⁷ <https://www.wmfe.org/politics/2022-12-13/florida-senate-passes-property-insurance-overhaul-during-a-special-session>

Positive impact on CAT Bonds

The market for Insurance-Linked Securities has been aware of the problems in the Florida market for many years. So CAT Bond investors, especially after the experiences following Hurricane Irma, have been pushing for the loss adjustment expenses (LAE), which go beyond the actual property damage, to be settled only via a fixed factor. The risk of an adverse development of this cost block then remains with the ceding company of the CAT Bond, i.e. the insurer. Likewise, cascading structures disappeared, i.e. CAT Bonds that drop down in the reinsurance programme after an initial loss event and whose risk increases accordingly from the investor's perspective. The shortage of reinsurance capacity in recent years, which was further accelerated by Hurricane Ian, has given ILS investors greater bargaining power to enforce these changes.

The reform bill reduces the risk for the ceding insurer that it will have to bear excessive claims settlement costs itself. CAT Bonds thus remain an attractive alternative to traditional reinsurance. At the same time, it increases the likelihood that the advantageous structures for investors will be maintained in the future. A revival of the private insurance market in Florida should also result in insurers seeking a path to the CAT Bond market, which should open up better selection and diversification opportunities for ILS investors. Finally, it is not very attractive if a large part of the transferred risk comes from one and the same cedant, which would have been the consequence if the insurance market had increasingly shifted to Florida Citizens.

Last but not least, other states will be looking very closely at the developments in Florida and critically assessing the state of their local insurance market. In Louisiana, for example, a special session is being sought on this topic, in which the state will probably follow Florida's example and adopt similar regulations that can reduce the cost of reinsurance and at the same time ease the pressure on Louisiana citizens.⁸

CAT Bonds even more attractive in the future

As CAT Bond investors with a long-term perspective on this market, we welcome these reforms. The legislative reform reduces the amount and uncertainty of claims settlement costs for future insured events in Florida. We anticipate that litigation costs related to claims settlement will be reduced by at least 50% as a result of this new law. This also affects the ratio of reinsurance premium income to expected claims payments and leads to an improved adequacy of the premiums charged, with a positive effect on the risk-adjusted compensation for CAT Bonds. In addition to reducing uncertainty about the final loss amount after a hurricane, the duration of claims settlement should also be reduced if fewer claims are litigated in court, which will provide CAT Bond investors with quicker clarity about the expected payouts. The existing uncertainty in the modelling will also be reduced if unilateral legal fees and assignment of benefits make a smaller contribution to the claim amount, as these are not included in the models.

Despite the reduced risks, we do not expect this bill to have a significant impact on the current premium level, which is mainly due to the high claims burden from past events such as hurricanes "Ida" and "Ian", rather than the litigation cost component of claims settlement. However, we expect the bill to make the Florida CAT Bond market more dynamic and diverse as new insurers enter the more attractive Florida market. This will provide CAT Bond investors with a broader and more diverse choice of investments in the future. Even before the legislative reform, the CAT Bonds market was very promising, with premium levels at a 20-year high. Combined with the improvements as a result of the law reform, this market will become even more attractive in the future.

⁸ <https://www.artemis.bm/news/reinsurance-affordability-to-prompt-louisiana-special-session/>

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