Community Finance Brief

A Defensive Capital Stack Isn't A Way Out For Florida

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Just ahead of what is is predicted to be "an extremely active hurricane season", the state of Florida raised $1 billion through the municipal bond market to shore up the state's property insurance industry. This particular funding supports the public reinsurer of the state. The system set up in Florida to back-stop its struggling property insurance industry has a lot of zeroes attached to it and is reinforced by the ability to levy assessments on a broad swath of the state's economy to remain intact.

A brief aside on the pricing and trading of the bonds, which tends to be skipped in policy discussions but in this instance is relevant: the secondary trading of the bonds has been underwhelming and early levels offered only a modest adjustment higher from initial pricing levels. In a marketplace where $1 billion double-A tranches are seeing overwhelming demand, this type of trading activity is *indicative of investor hesitancy* and likely means insurance headline risk is at play. During the pricing of the bonds, indications of interest started at +105 to the 10-year UST, eventually priced at +93 and did trade up to about +85 but overall minimal follow-through on the Street was seen on the trade tape. This means two things to our less bond-inclined readers: a state insurance conduit is paying nearly a full percentage point higher than a Treasury bond on $1 billion (or $10 million annually over 10-years) and it looks as through the marketing of Florida insurance bonds to investors has met some resistance.

Quick Takes

The average cost of home insurance in Florida is more than triple the national average as of Fall of 2023
– National Public Radio

In 2024 already, two Florida-based private insurers, Castle Key and Amica, have asked regulators to approve rate increases over 50% on some home insurance products
– Florida Office of Insurance Regulation

The cost of billion-dollar disasters between 2021 and 2023 in Florida alone of which there were 16 events is between $100 and $200 billion whereas between 1980 through 2023 there were 84 events costing between $300 and $390 billion
– National Centers for Environmental Information

Consider this: average homeowner insurance in the state has increased 63% from 2019 and 10 property insurers have been declared insolvent in that same time frame(per the state's presentation), the Florida Insurance Guaranty Association (FIGA) borrowed $600 million last year for the first time in over 30-years to help cover claims from said insolvent insurers and in 314 pages of legal opinions and explanations of last week's bond deal the word "climate" is used a single time.

All else equal, this is generally solid news for Floridians and its governments but in the face of the largest downdraft of insurance companies present in the country (and the major trigger of inflation), it is only healthy to question the market's logic in shoring up the status quo for a state where natural disasters have gone from acute to chronic and severity and costs of these events continues to escalate.

"There is a lot of cross-subsidization of risk in Florida," says **Carolyn Kousky,** associate vice president for economics and policy at the *Environmental Defense Fund*. "The state has three public insurance programs. At a high level, they are designed to pay severe loss years by turning to the bond market and then assessing property insurance policyholders in the state to pay back the debt. But the programs have authority to assess more than their own policyholders—many lines of insurance throughout the state can be assessed. That means that if you are a car owner in north-central Florida, your auto insurance could theoretically be assessed to pay the claims from the next big hurricane in Miami."

A BILLION TO FUND WHAT EXACTLY?

The central figure in this transaction is the Florida Hurricane Catastrophe Fund (FHCF), which is a public reinsurer for all property insurance companies that operate in the state of Florida. Important, but not essential, to risk transfer in the property insurance model, a reinsurer essentially provides insurance for insurance companies that pay a premium to the reinsurer in exchange for taking a portion of the risk associated with a specific policy.

The FHCF collects a mandatory premium from all residential property insurers and covers them for all residential losses of either 45%, 75% or 90% of its covered residential losses, depending on the level of reinsurance they have applied for. In plain speak, if your private insurer hits its own deductible of claims after an event, it can then draw funds from the FHCF to make its own payments. It's another layer of safety for the entire system of property insurers in the state.

FINANCIAL VIABILITY

Last week, the fund tapped the municipal bond market for $1 billion to increase its liquid resources to $11.2 billion for the 2024 hurricane season. As of last Fall, the fund also has the capacity to raise another $9.3 billion in post-event bonding, and can raise up to $3.8 in pre-event bonds in 2024, meaning it can legally raise even more money if needed later this year if the hurricane season is more damaging than expected.

What is key to the discussion today is liabilities that come in the form of natural disasters but we would be negligent in our duties of basic analysis if we did not point out that the FHCF also has outstanding debt that needs to be paid off that puts a sizable dent in the risk capacity of the previous figures. This includes a $1.25 billion principal payment in July of next year and overall $3.5 billion by 2030.

Assessment Base – Consistent Growth

It is prudent to recall that while these figures do not come directly out of taxpayer wallets (the fund is not set up that way), the assessments have an indirect impact on the local economy. The payments come from FHCF's legal ability to capture dollars from most any company in the insurance business in the state. Eventually these costs are passed on to residents.

Key to its financial viability is its assessment base (the entity itself is not connected to the state's credit and not does it have taxing power) that is relies exclusively on to make payments. Consistent with the growth in Florida's population and economic growth post-pandemic, the ability to capture dollars from other policies is at its strongest point ever (see figure, **above**).

In an investor statement the FHCF points out that it has the authority to levy assessments on a "broad and diverse base of property and casualty insurance policy in the state," which is further explained in a table (see figure, **below)** that points to the fact that while it is a reinsurer of property insurers, it can assess most other types of insurance companies that operate in a variety of businesses. It could be the case in Florida that a car owner in Jacksonville is helping pay claims for flooding in Miami. Such is risk transfer in the state of Florida. But the state assures investors that recent tort reform has strengthened the FHCF position from a legal liability on this issue and others.

Aside from this logical issue, barring a major change in the state's population or economic viability in the near-term, this is a strongly secured credit. What this does not address (and instead promotes) is a structural absence of common sense.

Insurable Lines Subject to Assessment		
Fire	Financial Guaranty	Commercial Auto Physical Damage
Allied Lines	Earthquake	Aircraft (all perils)
Multiple Peril Crop	Other Liability (occurrence)	Fidelity
Farmowners Multiple Peril	Other Liability (claims-made)	Surety
Homeowners Multiple Peril	Products Liability	Burglary and Theft
Commercial Multiple Peril (non-liability)	Private Passenger Auto No-Fault (PIP)	Boiler and Machinery
Commercial Multiple Peril (liability portion)	Other Private Passenger Auto Liability	Credit
Mortgage Guaranty	Commercial Auto No-Fault (PIP)	Warranty
Ocean Marine	Other Commercial Auto Liability	Aggregate Write-Ins for
Inland Marine	Private Passenger Auto Physical Damage	other Lines of Business

NATURAL DISASTERS IN FLORIDA

To model out financial scenarios of how and when and if the fund is tapped is tricky as each private insurer in the state has its own projections and different mechanics within which FHCF is called upon. That said, the level of damages needed to run this fund dry would be unprecedented. FHCF does what it is supposed to do: it further transfers risk amongst parties.

So, we turn then to a central, and consistent problem with how many are approaching climate change: they are looking to the past for answers. The problem with this is that climate change is fundamentally altering any historical precedent when it comes to the consistency and intensity of storms. In this case, the state tells investors how the fund has handled previous storms in the last 20-years (see figure, **below**) as evidence of its ability to withstand the future.

For this coming year in particular, the *El Nino* phenomenon has made the oft-quoted Colorado State University Tropical Meteorology Project to call for 23 storms, which is notably higher than the 30-year average. As the frequency of these storms increase, the cost of the storms do as well (see figure, **page 5**) and this further weighs on the property insurance sector. Overall, the broader impact of the increase in storms and their severity has challenging implications for state and local budgets and Florida is in the cross hairs, particularly because property insurance as it now stands, is predicated on pervious performance, not on the future.

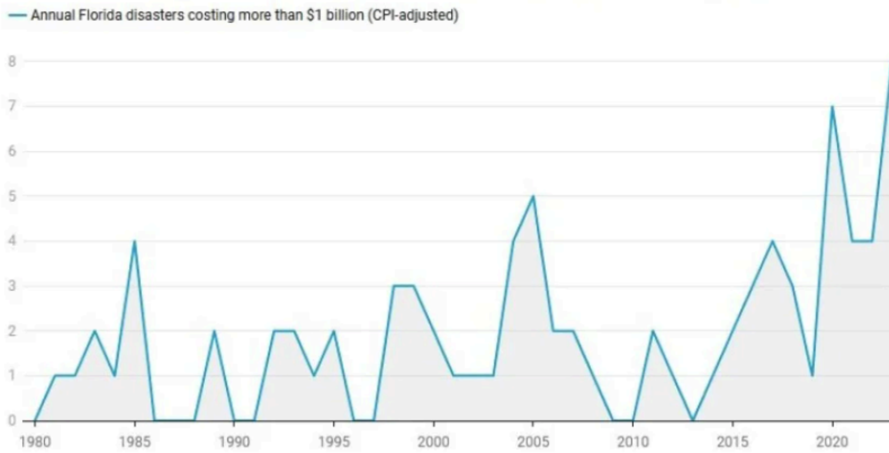
Hurricane Season	Covered Events	Number of Insurers Reimbursed	Total FHCF Reimbursements Paid	Total Reported Industry Paid in Florida	FHCF Paid as % Industry Paid	Storm Categories at Landfall
1995	Erin, Opal	9	$13 million	$2.0 billion	0.7%	1-3
2004	Charley, Frances, Ivan, Jeanne	136	$3.9 billion	$15.9 billion	24.3%	2-4
2005	Dennis, Katrina, Wilma	114	$5.5 billion	$11.6 billion	47.6%	3
2017	Irma	103	$7.5 billion	$16.3 billion	46.3%	4
2018[1]	Michael	38	$1.2 billion	$4.9 billion	23.7%	5
2022[1]	Ian	62	$3.5 billion	$11.4 billion	31.0%	4
2023[1]	Idalia	1	$0.1 million	$153 million	0.1%	3
Total	**13 Covered Events**		**$21.6 billion**	**$62.1 billion**	**34.8%**	

Source: Paragon Strategic Solutions Inc. Numbers in layer chart may not add due to rounding. Not drawn to scale. In this layer chart, the relevant data are aggregated for FHCF participating insurers. Total industry paid losses are as reported to the FHCF. Amounts are rounded.
[1] Represents losses paid and reported industry losses through February 29, 2024.

FHCF

THE INSURANCE PROBLEM

Last summer Allstate Corp. and State Farm announced they were no longer writing new homeowners insurance policies in California. This became a larger headline because the insurance issue has tended to focus on flood-prone Southeastern U.S. and wildfires were a newer problem that forced these two large insurers to announce these changes (this also impacted more middle- and upper-income people in the country).



Since this decision last Summer, the focus has increased on the insurance problem everywhere and while it is by no means new (the history of the policy debate over the National Flood Insurance Program is a proxy for that statement), it has grown in size. Late last summer the Council on Foreign Relations put together a good summary of the how and why we are here, and it is suggested reading for interested parties.

The financial problem associated with this issue is best understood at the global level: from 2017 to the start of 2024 the largest global property **reinsurance rate index was up 76%** as more accurate actuarial modeling takes better account of the implications of climate change on this business model. This is cited in the FHCF report to its potential bond investors last week as it said that insurers in Florida have increased their participation in the public reinsurer option in line with "the increase in global risk transfer price." As a result, the, Florida property insurance companies increased FHCF use by 46% from 2018 through 2023. All this means that private insurers in Florida are relying significantly more on the FHCF now than before.

In considering the statistics in the opening paragraphs about shuttered property insurers or the increase in prices, it does not fully take into account the global situation at hand and what the implications are for rates and actions this summer (and beyond). Further, the dependence on federal support via FEMA, which is a key element in the rebuilding effort, is under pressure as costs of storms have mounted. To underscore once again: with all these items considered, investors went long one billion Florida insurance last week for ten years.

THE SUNSHINE STATE'S INSURANCE MATRIX

Let us review some (hopefully most) of the moving state-approved moving parts of the insurance matrix:

- FHCF - discussed in *this brief;*

- Citizens Property Insurance Corporation - a statutorily created insurer of last resort that absorbs policies that are not able to be placed in the private market;
- FIGA - A guaranty association that we noted issued $600 million bonds last year to cover defunct insurers;
- Reinsurance to Assist Policy Holders (RAP) that is a state-funded program to offer no-cost insurance "layer of allocation" for the 2022 and 2023 hurricane; and
- Florida Optional Reinsurance Assistance that works with RAP to provide additional options reinsurance coverage from the state below the HFCF cover layer for the 2023 season that is funded by up to $1 billion by the state's general revenue pledge and insurers who purchased coverage.

This is a lot of government support (and does not include a lawmaker at the national level from Florida proposing a reinsurer sponsored by the federal government) for insurance in general and an increase of such support over the last two years coupled with legislation tamping down on the legal process of questioning claims. It is not surprising to hear bond traders this week mention headline risk associated with the latest bond deal and pointing to the lack of secondary trading late last week (and under 10 block trades as of 4:30 pm eastern time on Monday the 22nd) as a sign of future investor resistance to these types of transactions. This lack of activity is abnormal for an investment-grade taxable transaction of this size.

DEFENSE DOESN'T ALWAYS MAKE FOR A GOOD OFFENSE

The governorship of Ron DeSantis has made waves in the municipal market for push back on environmentally- and socially- related concepts that have taken hold in financial markets worldwide. They fall collectively under the idea that there are rates of return and risk assessments that should take into account people and the natural ecosystem they inhabit.

Given the system just described and that the funding mechanism is tied to the municipal bond market, one can't help but consider that this financing and the overall approach could be more forward thinking. The muni market is more and more being considered as an agent of change in community finance. Connecting the environmental and social effects of programs funded by municipals securities is growing in popularity.

It is clear that the financial infrastructure in place state-wide defends the status-quo amply. But it is quite costly and will continue to be so. It would behoove the state's civil servants to pair this capital stack with commitments to resilient infrastructure and adaptation finance. Creative ideas around insurance such as community-based catastrophe insurance and parametric policies could be salves instead of relying wholeheartedly on a system that by all intents and purposes is broken.

Insurance was not designed for massive single-events wherein the geography of claims are so clustered. One cannot mitigate that effectively. Add somewhat proper actuarial modeling to that mix and the system ceases to function. This bond deal propagates this broken approach and came and went with little fanfare. Floridians deserve better.