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## Increasing the Cat Fund's Capacity is Good Public Policy

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The Florida Hurricane Catastrophe Fund (Cat Fund) is a tax-exempt state trust fund that was created after Hurricane Andrew to make sure that the insurance system could pay homeowners' claims from a major hurricane and continue to renew policies after the storm. It is the lynchpin of the state's property insurance market and is critically important to the state's economy. The Fund operates as a public-private partnership to create funding for catastrophic hurricanes without putting the state's general revenues at risk. The Fund's structure is designed to minimize the role of government in the market by focusing on providing a stable, low cost source of capacity, leaving the private sector to issue policies and pay claims.

The Cat Fund currently provides \$11 billion of capacity. It is the largest source of hurricane reinsurance capacity in the world, yet it only incurs expenses of only 1% of premium and has 8 employees (private sector reinsurers have expense ratios of 10% to 20%). It is funded by payments from insurance companies and has the ability to issue bonds secured by emergency assessments if its cash is not enough to meet its obligations. Since its inception, the fund has accumulated approximately \$5.5 billion in cash and has saved Florida's consumers billions of dollars of insurance premiums.

Fundamentally, the Cat Fund is a hurricane financing mechanism. It has three sources of revenue: premiums paid by insurance companies, investment income on its accumulated cash balance, and emergency assessments to retire bonds. It compliments traditional financing mechanisms, including private reinsurance. The major distinction between the Cat Fund and traditional systems is the timing of when funds are collected. The Cat Fund collects revenue from premiums and holds pre-event reserves of only accumulated cash, making up any shortfall between claims and cash reserves by issuing bonds and retiring them by making assessments. Traditional reinsurers collect all funds in premiums and hold capital reserves sufficient to meet claim obligations without any post-event assessments. The Cat Fund's assessments should be viewed as a deferred premium, and a proper comparison of the Cat Fund and traditional reinsurance should consider both the up front premium and post-event assessment as part of a revenue stream supporting the payment of hurricane claims.

The Cat Fund offers many benefits to the people of Florida:

- It increases the availability and affordability of property insurance coverage for Florida consumers by offering a low-cost source of hurricane funding.
- It stimulates economic activity by allowing development to continue in coastal areas.

- It protects Florida's economy from a post-hurricane market meltdown through its ability to renew its coverage the year after a storm without a rate increase.
- It leads to less government by encouraging private sector insurance companies to write coverage, reducing the size of the residual market (Citizens).
- It keeps billions of Florida consumers' premium dollars in a tax-exempt trust fund under state control, rather than sending them to offshore reinsurers.

In 1999, the Cat Fund was restructured to assure that it was capable of restoring its ability to provide protection once a major hurricane depleted its resources. At that time, its payout for a single hurricane season was capped at \$11 billion to allow the buildup of capacity for later hurricanes. While the fund's payout was capped, Florida's coastal population continued to grow. If the fund is going to continue to provide protection for Florida's homeowners and Florida's economy, its payout needs to catch up with Florida's growth.

This year's legislation would strengthen the Cat Fund by raising the maximum payout ("capacity") of the fund to \$15 billion and allow it to keep pace with Florida's future growth, while protecting the important reforms enacted in 1999. The legislation responsibly funds the extra capacity by including unregulated surplus lines policies in the assessment base and increasing the limits on those assessments to protect the Fund's ability to issue bonds.

The legislation is being opposed by special interests that fear that their profits may be threatened by the State's efforts to better prepare for the next hurricane. They are trying to mischaracterize the emergency assessment authority needed to support the Cat Fund's capacity as a tax, hoping to divert attention from the issue of the availability and affordability of property insurance. The word "tax" is often used in today's political climate as a pejorative term in a context of implying irresponsibility and lack of sensitivity to the burden it places on citizens of the state.

The Cat Fund is not about bigger government or more tax revenue; it is about preparing for hurricanes and funding the inevitable losses at the lowest possible cost. In fact, preparing for hurricanes lowers government's role in their aftermath, reducing long term government spending.

By creating the Cat Fund, Florida's Legislature has elected to use a mixture of pre-event and post-event funding for major hurricanes to lower the long-term cost of financing hurricanes. While there is a legitimate debate over the appropriate balance between pre-event vs. post-event funding of losses, neither the pre-event premiums nor post-event assessments are "taxes;" they are simply different methods of funding the inevitable hurricane loss.

Funding by emergency assessments is contingent on a large hurricane event and, as such, is expected to be infrequent and limited to a small percentage of the premium for an insurance policy. Under the proposed legislation, the emergency assessment required to fund bonding needs would be around 2.5% for an event that exhausts the proposed \$15 billion capacity in an initial season. There is only a 2% chance that the maximum bonding amounts will be needed and an event of this magnitude would be expected to occur only once every 50 years. The probability of a hurricane event triggering any amount of bonding is about 5% and is expected to occur once every 20 years.

Private reinsurance capacity is highly volatile and cannot be relied on to stabilize the residential property insurance market in Florida. After Hurricane Andrew, private reinsurance capacity severely contracted and prices skyrocketed, triggering the market crisis that left a million consumers without private sector insurance and forcing the state to step in to write insurance coverage through pools. Thanks to the Cat Fund, the private sector was able to recover and depopulate the residual markets.

Unfortunately, since 1999 the inability of the Cat Fund to grow with the market has contributed to an increase in the number of consumers forced into Citizens Property Insurance Corporation, a state sponsored insurance company which writes policies for risks that cannot find coverage in the voluntary market and covers its deficits with assessments. By strengthening the Cat Fund through the proposed legislation, the state will encourage the private market to write these risks and reduce the state's role in the insurance market.

Increasing the potential emergency assessment authority in order to create additional Cat Fund capacity is good public policy since it will enable insurers to write more business in the voluntary market. It makes more sense for the Cat Fund's capacity to grow than to allow the residual market (Citizens) to continue to grow. Currently, the voluntary market lacks the capacity to cover all of Florida's exposure, partly as a result of the inability of the Cat Fund to grow in recent years. Absent additional Cat Fund capacity, the excess exposure is being covered by the residual market (Citizens). The Cat Fund's emergency assessment authority will only be used for large events and time between such events may minimize their cost to the public. In addition, the Cat Fund assessments are spread over a broad base of policyholders over time thus enabling the efficient spreading of large shock losses. The continued growth of Citizens is creating a growing and substantial burden on a large number of policyholders who are required by law to pay the highest premiums in the state. It also results in a greater government role in the property insurance market, as Citizens issues policies and pays all claims, as opposed to the Cat Fund, which simply provides capacity for major hurricanes. The growth of Citizens actually creates a serious economic threat due to Citizens potential need for assessments which can be sizeable and are only spread over a limited base of policyholders. Increasing the Cat Fund's capacity will benefit the state by reducing the size of Citizens and lessening the need for Citizens' assessments.



## ABOUT THE AUTHOR

Tom Gallagher was sworn in as Florida's first Chief Financial Officer in 2003. His constitutional responsibilities include overseeing the state's fiscal health, keeping track of more than \$53 billion coming in and out of state government annually and auditing state programs to make sure taxpayer dollars are accounted for and appropriately spent.

Tom Gallagher's life in public service began in 1974 when he was elected to the Florida House of Representatives. He served for 13 years in the House, seven of which were spent as the only Republican in Miami-Dade's delegation.

In 1987, Governor Bob Martinez appointed him Secretary of the Department of Professional Regulation, and in 1988, he was first elected to the Cabinet position of State Treasurer, Insurance Commissioner and Fire Marshal. As Insurance Commissioner, Gallagher is best known for his leadership in the aftermath of the nation's most devastating and costly natural disaster – Hurricane Andrew. During his tenure, Gallagher also spearheaded the creation of the Healthy Kids Corporation, a program that provides health insurance to nearly 300,000 children in low income families in Florida. After serving as Education Commissioner from 1998-2000, Gallagher was again elected State Treasurer in November 2000.

In 2002, Gallagher was instrumental in the passage of a consumer-friendly bill creating Citizens Property Insurance Corporation. Citizens, resulting from the merger of the state's two residual markets, offers property insurance coverage to homeowners unable to obtain it in the private market. During the 2003 Legislative session, Gallagher persuaded lawmakers to enact legislation putting an end to predatory rating practices used by out-of-state health insurance companies. Gallagher also successfully pushed for increased penalties for individuals and businesses selling unlicensed insurance or committing workers' compensation fraud.

Gallagher is married to the former Laura Wilson, a sixth generation Floridian from Madison, Florida. Tom and Laura are the proud parents of a 5-year old son, Charlie.

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