

Rating Implications of Recent Florida Legislation

In response to the recently passed insurance legislation in Florida and in the ongoing effort to maintain rating transparency, A.M. Best provides the following commentary regarding both the near-term and longer-term impact of this legislation on the financial strength ratings of primary and reinsurance companies.

The legislation was the result of a special session called specifically to address the affordability and availability of property insurance in Florida. Key measures of the act are the substantial increase in the amount of hurricane losses covered by the Florida Hurricane Catastrophe Fund (FHCF); revisions regarding the rate-approval process; changes to the state-sponsored Citizen's Property Insurance Corp. (Citizens); and nonrenewal restrictions.

The legislative changes were significant and may have far-reaching consequences in the Florida insurance market. As a result, A.M. Best will be evaluating the exposure of companies to recoverables from the FHCF and the impact on the companies' overall capitalization. Companies most exposed to negative rating pressure and rating downgrades will be those with large gross catastrophe exposure, and thus greater exposure to FHCF recoverables. Over the longer term, the impact of these changes to insurers and reinsurers is likely to be one of increased competitive pressure both within and outside Florida. Overall, the impact on a company's rating will be largely dependent on several factors; key among them is each organization's unique ability to manage through the regulatory and market challenges that lie ahead while maintaining adequate pricing and favorable risk-adjusted capitalization.

A.M. Best's rating philosophy is based on a comprehensive analysis of three key evaluation areas; balance-sheet strength, operating performance and business profile. It is the interaction of these three components that will determine

an organization's financial strength and Best's Rating. While the foundation of all financial strength ratings is an organization's balance-sheet strength, a strong business profile and effective risk management provide a base from which an insurer can drive future operating performance, which ultimately will allow a company to maintain appropriate risk-adjusted capitalization. An important consideration in the analysis of business profile involves concentration of risk. This concentration can encompass a number of areas, including catastrophes, competitive market conditions or, as is the case here, regulatory pressures. Accordingly, for those companies with a concentration of business in Florida, these issues previously have been incorporated into A.M. Best's assessment of their business profile and ultimately the assigned rating.

Rating Analysis Impact

With the significant changes to the FHCF, A.M. Best believes it is prudent to increase the credit risk factor assigned to reinsurance recoverables derived via the fund. As a result, the credit risk factor for use in Best's Capital Adequacy Ratio model (BCAR) on a stress-tested basis will be 12% for recoverables from the FHCF. The increase in the credit risk factor is a result of A.M. Best's concerns regarding the contingent capital nature of the FHCF; the execution risk associated with the post-event issuance to pay for losses; the long-term impact on the insurance markets; and the uncertainty in the market subsequent to a major event. In addition to the FHCF, state and local governments as well as other insurance-related entities likely will need to issue bonds and additional assessments to pay for losses related to a major storm.

Given the expanded coverage of the fund, A.M. Best's concern lies with the capital markets' acceptance of what likely could be the largest public debt offering in U.S. history, assuming a significant hurricane event. In addition, as it applies to primary insurers, the potential liquidity and cash-flow issues that might arise from such an event provide an additional

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level of uncertainty. Lastly, the FHCF's obligation to participating insurers is limited to its claim-paying capacity, which is partially dependent on the post-catastrophe debt issuance. As a result, participating insurers in the fund may not be fully indemnified for their losses in the event of a "mega" catastrophic event. A.M. Best may lower the charge in those cases where collectibility is more likely, such as for limited apportionment companies that have a statutory priority in the recovery process.

A.M. Best will continue to remove the potential for dispute risk regarding the FHCF from the assessment of risk-adjusted capitalization as determined by BCAR. Dispute risk represents the unwillingness to pay vs. the credit risk component's ability to pay. As such, A.M. Best continues to view the dispute risk associated with the fund as minimal, given the FHCF's unique structure as a state fund administered by the State Board of Administration and its role in Florida's overall economy.

Also included in the legislation is the ability for the Florida Office of Insurance Regulation to waive or lower the deposit requirement for reinsurers licensed in other countries based on criteria related to the financial strength of the insurer and the quality of the regulatory jurisdiction. For the most part, the removal of this provision will have minimal impact on A.M. Best's view of primary companies' baseline risk-adjusted capitalization. However, in the case of A.M. Best's Stress Test—which contemplates the capitalization of a company after a catastrophic event and includes the related reinsurance recoverables—the removal of letters of credit or other reinsurance credit enhancements may be viewed negatively. Put simply, risk is increased when collateral requirements are lowered, all else remaining equal. This is particularly true for those companies with significant dependence on alien reinsurers where these agreements provided benefit in A.M. Best's previous assessment of stressed risk-adjusted capitalization.

Primary Market

While the regulatory environment in which a company operates is incorporated into all ratings, A.M. Best views the recent legislative changes as weakening the business profile of companies with significant concentration of Florida business. In addition, the prospective capitalization of property insurance writers is weakened, as they carry the burden of potentially unrecoverable reinsurance in the event of a

major, catastrophic event.

The changing regulatory environment as it applies to the rate-filing process and increasing presence of Citizens as a competitive writer likely will reduce the profitability of primary companies. In particular the deletion of the "rate-flex" provision that allowed residential property insurers to increase or decrease rates by up to 5% on a statewide average basis or 10% for any territory likely will adversely impact operating earnings. Further pressuring prospective profitability is the suspension of the "use and file" rate-filing procedures. In addition, uncertainty remains regarding the definition and ultimate prohibition of "excess profits."

Last, the changes to be implemented at Citizens, including rate rollbacks, represent additional competitive pressure on existing companies. With Citizens offering what appears will be a competitive product and a competitive price, without comparable reinsurance protection, the longer-term impact to existing players is uncertain. However, for those looking to scale

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back operations in Florida or minimize their overall risk exposure, a more competitive Citizens may help facilitate this reduction.

The combination of these factors results in a significant amount of uncertainty regarding the stability of the Florida market after a catastrophic event. This uncertainty is heightened given the consensus expectation regarding increased frequency and severity of catastrophic events.

Reinsurance Market

As it applies to the reinsurance segment, A.M. Best does not believe that the reforms will directly impact the financial strength ratings of reinsurers at this time. As a result of the insurance reforms, the FHCF could double its capacity while continuing to charge below-market rates. Although these measures are directed at lowering the state's homeowners' property rates, they will have a pronounced bearing on the competitive landscape for Florida reinsurers and a more subtle effect on the broader domestic and global reinsurance markets.

The reforms are expected to eliminate billions of dollars of reinsurance premiums from the private reinsurance market, which could result in a considerable amount of capacity becoming available for redeployment. As they look to recapture lost revenue, the manner in which reinsurers react to the legislative curtailment of the Florida reinsurance market could accelerate rate softening in noncoastal property regions and result in increased competition in casualty lines. Carriers actually could reduce overall catastrophe exposures with global property diversification, despite increased writings in areas outside of the United States, if the growth is done prudently. A.M. Best expects this measure to force reinsurers that were expecting a smooth July 2007 catastrophe renewal to once again reassess capital-management strategies.

Given the size of the Florida catastrophe market, these changes will affect reinsurers in the context of premium generation and operating margins. Those reinsurers that derive a majority of revenue from property writings will be the most impacted on both the top and bottom lines. However, those reinsurers that maintain a

rational approach to capacity allocation under these difficult circumstances potentially could strengthen their risk-adjusted capitalization while sustaining reasonable returns on capital. With the absence of hurricane activity in 2006 and the benefit of considerable rate increases, the majority of carriers with Florida property exposures reported record earnings. Conversely, these same reinsurers could have lost billions of dollars had catastrophe activity mirrored that of 2004 and 2005, which highlights the risk-reward dynamics of the Florida catastrophe risks. Far too often, the question of risk versus reward is forgotten in those years when a catastrophic event does not occur.

A.M. Best expects that as easily as capital poured into the Florida markets to address serious capacity shortages, there will be pressure to either return capital to shareholders or redeploy capital in other markets outside of Florida. Moreover, the alternative sources of capacity such as sidecar formations and start-up operations that arose in 2005 and 2006 will decline significantly due to the unexpected increase in reinsurance capacity. Additionally, A.M. Best expects that the pricing for Industry Loss Warranties (ILWs) will become more competitive as it relates to U.S. Gulf catastrophe risks.

Summary

Over the long term, A.M. Best believes the recently enacted legislation in Florida will have an operational and earnings impact on both the primary and reinsurance segments. In addition, it is anticipated that after a significant catastrophic event, considerable dislocation will put additional pressure on the market, and the regulatory and political response to such a situation is uncertain. Beyond Florida, if similar, state-sponsored reinsurance systems are adopted, this likely would result in further contraction of the private reinsurance market.

Going forward, A.M. Best will continue to monitor and evaluate the various market dynamics in Florida and their impact on A.M. Best's rating opinions. In addition, A.M. Best's assessment of the credit risk component of the Florida Hurricane Catastrophe Fund and its impact on risk-adjusted capitalization will be monitored on an ongoing basis.



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