M E M O R A N D U M

TO: **Dr. Jack Nicholson**
Gen. Bob Milligan

FROM: **John Forney**
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RE: **FHCF Hurricane Season Funding Update**

DATE: **June 6, 2008**

Introduction

The Florida Hurricane Catastrophe Fund ("FHCF") enters the 2008 hurricane season with larger useable cash resources than it has ever had before – over $8 billion -- and a multi-year claims-paying capacity of over $55 billion. A storm causing residential insured losses of over $15 billion would be required before any bonding would be needed by the FHCF. A storm of such size would rank behind only Hurricanes Andrew and Katrina in terms of insured damages[1]. If bonding is required, the FHCF enjoys ratings in the AA category from all three major rating agencies, and has successfully accessed the markets three times in the past two years. Its senior managing underwriter team (consisting of Citi, Goldman Sachs, J.P. Morgan, and Lehman Brothers) believes that, even in the currently difficult market environment, the FHCF could raise at least $10 billion in the bond markets in the first several months after an event[2].

Despite this strong financial picture presented by the FHCF, concerns remain about its ability to meet its maximum potential obligations in an extreme storm event. For the 2008 storm season, this maximum obligation for the FHCF could be over $29 billion. The resources described above, including the estimated amount of bonding accessible with reasonable certainty according to the FHCF senior managers, come to about $18 billion. This is a substantial amount of near-term claims-paying capacity, especially considered in light of the fact, that, in the wake of the eight storms that impacted Florida in 2004 and 2005, the FHCF paid out less than $9 billion. However, given the fragility and volatility of the financial markets in the past year, if the FHCF is called on to bond for its maximum obligation in a short period of time there is the potential for up to an $11 billion temporary financing shortfall that could cause reimbursement payments to be delayed. While the FHCF is only legally obligated to pay claims up to *"the actual claims-paying capacity of the fund*[3]*,"* which in practical terms means that if the FHCF cannot raise sufficient money in the bond market it is not legally liable to pay the losses above what it can raise, a failure of the FHCF to pay such losses after a storm could have serious implications for the insurance market and economy of the State of Florida. Therefore it is prudent for the FHCF to consider the tools available

[1] Source: ISO's Property Claim Services Unit; Insurance Information Institute.
[2] Source: Discussion with senior manager team, 5-16-08.
[3] Florida Statutes, Section 215.555(4)(c)1.

to it to provide additional certainty of payment after an extreme event, and to evaluate those tools from an effectiveness and cost standpoint. This memo provides a framework to assist in that analysis.

Funding Needs of the FHCF

The FHCF serves as a low-cost reinsurance mechanism to reimburse participating insurers for their covered losses after a hurricane in Florida. Before accessing the FHCF, insurers must meet a retention (deductible); after meeting the qualifying level for reimbursement from the FHCF, insurers receive up to 90% reimbursement and are responsible for the remaining amount (co-pay) of losses. The total liability of the FHCF is statutorily capped; this amount of potential reimbursement is allocated to each participating insurer based on its risk-weighted exposure in the State. In exchange for this coverage, each insurer pays the FHCF an annual reimbursement premium. Coverage provided by the FHCF consists of a mandatory coverage (which all participating insurers must purchase) and various optional coverages.

The principal coverages provided by the FHCF may be summarized as follows:

	Amount	Probability of Exhaustion
Type of Coverage [a]		
Limited Apportionment Coverage - Optional [1]	$ 600,000,000	N.A
Mandatory Layer	16,530,000,000	3.13%
TICL Layer - Optional [b]	12,000,000,000	1.64%
Total Potential FHCF Coverage	**$29,130,000,000**	

[a] Does not include TEACO coverage since lower pricing is available in the private market.

[b] Amount of coverage is estimated; since the coverage is optional, it is not yet clear how much will be purchased.

The resources available to the FHCF to meet these potential obligations include (i) its cash on hand (which can be derived either from accumulated reimbursement premiums and investment income thereon or the proceeds of pre-event financing arrangements); and (ii) the proceeds of post-event revenue bonds secured by emergency assessments levied on a broad range of property and casualty insurance premiums in the State. A breakdown of the existing and projected funding resources available to the FHCF to meet its funding needs is as follows:

	Amount
Currently Available Resources	
Projected Year-end 12/31/08 Cash Balance	$ 3,620,000,000
2006A Pre-Event Notes *	1,000,000,000
2007A Pre-Event Notes	3,500,000,000
Sub Total	**$ 8,120,000,000**
Projected Future Available Resources	
Post-Event Tax-Exempt Bonds	10,000,000,000
Total Available and Future Resources	**$ 18,120,000,000**

*** adjusted for non-extended maturities**

FHCF Liquidity Overview

The plan of finance for the FHCF has always assumed that a significant portion of the FHCF's claims-paying ability would come from post-event bonding. The ability of the FHCF to access the financial markets post-event as a result of its high credit quality and assessment capability is one of the principal reasons the FHCF can more efficiently address the timing risk of large hurricanes than can the private sector. Despite this structural feature, it has always been important for the FHCF to have enough cash, or ready access to cash, to pay claims for some interim period while it readies a post-event financing. This is the liquidity position of the FHCF. For 2008, the liquidity position is approximately $8.1 billion, as shown above. This is the strongest liquidity position the FHCF has ever had entering a hurricane season.

To aid the FHCF in evaluating the sufficiency of its liquidity position, the FHCF's consulting actuaries, Paragon Strategic Solutions, have prepared a table estimating FHCF payouts in various time periods after hurricane events of different magnitudes. That table for the 2008 hurricane season is as follows:

Florida Hurricane Catastrophe Fund
2008 Liquidity Analysis
$ in thousands

		Scenarios			
Return Time (years)		**10**	**20**	**50**	**100**
Probability of Occurrence		**10%**	**5%**	**2%**	**1%**
Gross Loss to FHCF Subject Policies		$9,384,780	$17,454,564	$32,769,743	$50,425,284
Estimated FHCF paid					
Month	1.0	$16,189	$30,109	$56,528	$86,984
Month	1.5	$146,963	$273,334	$513,166	$1,228,693
Month	2.0	$277,738	$516,560	$969,805	$2,370,402
Month	2.5	$337,027	$626,830	$1,541,002	$4,797,063
Month	3.0	$396,316	$737,101	$2,112,198	$7,223,724
Month	3.5	$476,842	$886,869	$4,377,826	$10,699,100
Month	4.0	$557,368	$1,036,637	$6,643,453	$14,174,476
Month	4.5	$621,815	$1,683,996	$8,710,222	$17,343,853
Month	5.0	$686,262	$2,331,355	$10,776,990	$20,513,230

Source: Paragon Strategic Solutions
4

The FHCF has always considered three months a sufficient period of time to execute a post-event financing of some type. Using this standard, the table above shows that the FHCF has ample liquidity for either a 1-50 year storm event or a 1-100 year storm event. Obtaining additional liquidity for timing purposes, then, is not a primary goal of the FHCF for 2008, especially given the high cost of such liquidity in current financial markets.

Potential Additional Funding Needs

In addition to having sufficient liquidity, the FHCF should also have some reasonable certainty of its ability to access the financial markets to obtain sufficient amounts to pay its obligations in a timely manner after a large storm event. The table

[4] Important Notes and Limitations of these Estimates:

1. This analysis assumes FHCF industry coverage of 89.777%, retention of $6.878 billion and limit of $28.53 billion. It does not include any potential FHCF liabilities for TEACO or special coverage for "limited apportionment" companies. Both of these layers would be more likely to incur losses than the FHCF, and so payments for them would be faster than what is represented here.
2. This analysis relies on loss reporting and reimbursements from 2005's Hurricane Wilma. While Wilma was the most significant storm faced by the FHCF to date, it does not reflect the entire range of loss reporting and reimbursements that can be experienced by the FHCF. A different storm striking a different location will result in a different mix of large and small companies incurring losses in excess of their retentions, and perhaps in excess of their FHCF limit. Future events could also differ from past experience as company behavior changes due to either new internal practices or legislative requirements.
3. By being limited to actual data from Hurricane Wilma ($11.3 billion of incurred loss as of June 2008), it is a very large extrapolation to make conclusions about reimbursement timing for storms causing much larger losses. Furthermore, TICL coverage did not exist in 2005 when Hurricane Wilma occurred, so we are less confident that full losses that might have been reimbursed by the FHCF for the TICL layer were accurately and promptly reported to the FHCF.

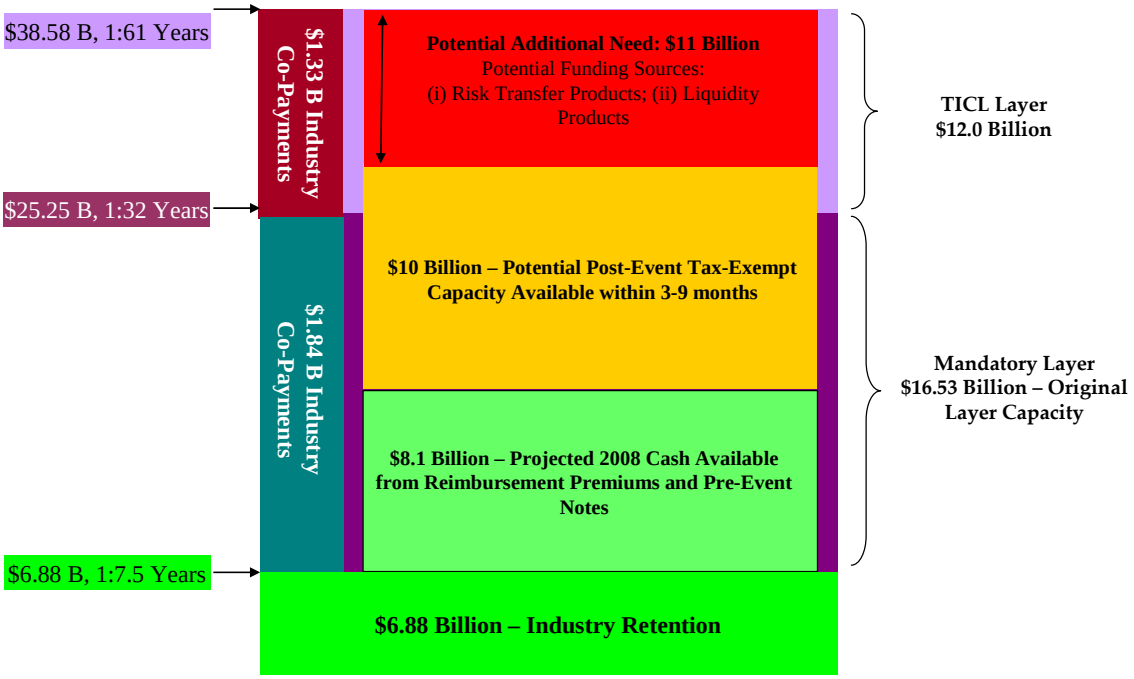
below shows the estimated payouts at 6-month intervals for storms of various sizes, based on extrapolations from actual experience with Hurricane Wilma.

Florida Hurricane Catastrophe Fund
2008 Funding Timing Analysis
$ in thousands

		Scenarios			
Return Time (years)		**10**	**20**	**50**	**100**
Probability of Occurrence		**10%**	**5%**	**2%**	**1%**
Gross Loss to FHCF Subject Policies		$9,384,780	$17,454,564	$32,769,743	$50,425,284
Estimated FHCF paid					
Month	6.0	$797,941	$4,527,311	$14,864,191	$26,780,684
Month	12.0	$771,194	$6,688,330	$18,708,021	$28,530,000
Month	18.0	$896,694	$7,486,777	$19,993,717	$28,530,000
Month	24.0	$1,220,555	$7,880,052	$20,518,729	$28,530,000

Source: Paragon Strategic Solutions
[5]

The chart above shows that, after a 1-100 year event, the FHCF could be required to pay out its entire obligation of nearly $29 billion within 12 months. However, as discussed above, the FHCF's senior manager team only feels confident with approximately $10 billion of post-event bonding in that time frame. This leaves an amount of approximately $11 billion where the FHCF could seek to bolster its post-event payment certainty. This situation is graphically depicted below:



[5] See footnote on page 4.

However, the payout table also shows that, given the assumptions contained therein, the FHCF could have a period longer than two full years to pay its obligations after a 1-50 year event, which would be large enough to eventually require the maximum payout from the FHCF. This type of extended payout period could give the FHCF time to bond for additional amounts that may not be available in the months immediately after a storm, and gives greater comfort to the FHCF's ability to meet its obligations in a timely manner after a large event.

Funding Certainty Enhancement Overview

The FHCF has been actively evaluating its options for providing additional post-event certainty of payment for several months. These options can be broken down into two broad categories:

Risk Transfer Options: these options, which include traditional reinsurance as well as some alternative risk transfer products, provide additional post-event payment certainty simply by transferring the risk of loss to a third party other than the FHCF.

Liquidity Options: these options provide the FHCF additional liquidity, either now or after a storm, but do not transfer the risk of loss. Post-event payment certainty is enhanced via these options by reducing the reliance on post-event bonding in the months immediately after an event.

There are many subcategories and specific products that could be analyzed in each category. In narrowing down these options, we kept several goals in mind:

1) Capacity – the amount needed to provide complete funding certainty is quite large -- $11 billion – so products with a small amount of capacity are not particularly helpful, all else being equal. We therefore focused on products that the FHCF's financial services team felt had at least $1 billion in capacity.
2) Cost – while bolstering post-event claims-paying certainty is important, the FHCF should not attempt to do this without regard to cost. Under the FHCF statute, all such costs may have to be included in setting the reimbursement premium rates,[6] so all such mechanisms ultimately result in upward pressure on insurance premiums in the State.
3) Executability – choosing a product that cannot be executed with reasonable certainty in a timely manner would not do the FHCF or its participants very much good. We therefore focused on established products with clear markets, or on those which the financial services team felt confident that execution risk was minimal.

[6] Florida Statutes, Section 215.555(2)(a)

Product Discussion

Risk Transfer Options

Overview

In general, traditional risk transfer products are not ideal to address the situation faced by the FHCF, since they do more than is required, and are therefore relatively costly. What is required is to address the fact that there may be a period of time – which could be lengthy – after an event when the FHCF could not access the financial markets to realize enough proceeds to pay claims in a timely manner. Eventually, given the strength of its repayment mechanism, the FHCF should be able to borrow the amounts it needs to pay claims. The ideal product, therefore, would provide a bridge over this potential timing gap. Risk transfer products, however, simply transfer the risk away from the FHCF, so that borrowing to pay the claims is never required. While this may be attractive for other reasons – foremost of which is that it could reduce assessments after a large event – it comes at a high upfront cost that would either (i) reduce liquidity and increase assessments for smaller events or (ii) increase premium levels for FHCF participants and ultimately for Florida consumers, perhaps significantly. In addition, a large purchase of reinsurance by the FHCF could reduce the capacity available for other Florida market participants that may need it as part of their capital plan.

One way to reduce the cost of any risk transfer product is to structure it to target the area where the FHCF believes it needs to have its post-event funding certainty bolstered. To do this, some combination of the following structural features would be attractive:

(1) the product is triggered (i.e., can only be accessed) above a certain level of losses designed to coincide to the top of the FHCF's confidence level in post-event funding;

(2) the product has a further trigger that allows it to be used only if the FHCF cannot access the bond market post-event in a timely manner; and

(3) the product recognizes that it is likely that eventually the FHCF will be able to access the bond market, and therefore allows for a credit or repayment of amounts paid by the FHCF when this does occur.

Traditional risk transfer products do not contain either (2) or (3) above. While including these features would be helpful, it also introduces a degree of customization that may reduce capacity and/or increase execution time.

Risk Transfer Products

The primary risk transfer products available to the FHCF include[7]:

i. **Reinsurance** – essentially a contract whereby a third party reinsurer would agree to pay the losses of the FHCF above a certain level, up to a specified maximum, in exchange for an upfront payment. Typically these are one-year contracts.

ii. **Catastrophe Bonds** – a collateralized, multi-year (typically 3-5 years) form of reinsurance. This accomplishes the same thing as traditional reinsurance, but does it via the issuance of highly structured bonds that pay a high rate of interest to investors; however, upon the occurrence of an event giving rise to losses above a pre-determined level, the issuer's obligation to pay interest and/or principal is removed.

iii. **Industry Loss Warranties** – index-based reinsurance contracts that are sold in the capital markets; similar to traditional reinsurance, but payments are based on an industry index of losses rather than a company's specific losses.

iv. **Sidecars** – a special purpose reinsurer that would reinsure only one company's risks – in this case the FHCF – by sharing proportionally in premiums and losses. Outside investors into the sidecar provide the risk transfer element.

The FHCF has evaluated these options thoroughly and over many years. It has never purchased reinsurance, primarily because of the fundamentally negative economic tradeoff caused by the fact that the FHCF would be buying reinsurance coverage at a price that is 4-5x (or more) higher than the price at which the FHCF currently sells the same coverage to its participating insurers. The significant premium outflow caused by such an economic decision would, as discussed above, either (i) reduce liquidity and increase assessments for smaller events or (ii) increase premium levels for FHCF participants and ultimately for Florida consumers, perhaps significantly.

The other three options – cat bonds, ILWs, and sidecars, have also been thoroughly vetted by the FHCF and its financial services team, both this year and in previous years (see, for example, an SBA report entitled *"Florida Hurricane Catastrophe Fund – The Feasibility of Purchasing Risk Transfer Products,"* dated April 12, 2007 for a detailed analysis of these options for the FHCF). They all suffer from one or more shortcomings - including high costs, low capacity,

[7] For a more comprehensive discussion of these products, see *"A Study of Private Capital Investment Options and Capital Formation Impacting Florida's Residential Insurance Market"* State Board Administration of Florida, September 19, 2006.

complex and time-consuming execution, and basis risk - that make them suboptimal choices for the FHCF given its current situation.

One variation in the risk transfer spectrum is a pure **"bonding shortfall product."** Such a product would have the counterparty pay the FHCF for a specified loss layer if, and only, if (1) losses reached the specified level; and (2) the FHCF were unable to bond for that layer. The FHCF has been seeking to craft such a product dating back as far as 1999. This type of customized product was sold in the private market last year to FHCF participating insurers who had concerns about the FHCF's funding capability after an event. This year, given the dramatic constraints felt by all major financial services firms as a result of the ongoing global financial crisis, it is not clear that a significant amount of capacity is available to the FHCF for such a product, or under what terms it could be realized.

Therefore, in the risk transfer space, it appears that the only feasible product that has the potential to meet the criteria described earlier in the memo is traditional reinsurance. The table below summarizes the estimated costs for this product at various levels of capacity. The cost estimates assume a starting point for attachment at the bottom of the TICL layer, which has approximately a 3.1% chance of being reached by storm losses. The cost estimates for each successive layer are cumulative, not incremental (e.g., the 20% cost for the $3 billion option would apply to the entire $3 billion):

Primary Risk Transfer Product Options Summary

Product	Capacity	Estimated Annual Cost (%)	Estimated Annual Cost ($)	Annual Cost/billion of capacity ($)
Traditional Reinsurance	$1,000,000,000	15%	$150,000,000	$150,000,000
	$1,600,000,000	17%	$272,000,000	$170,000,000
	$3,500,000,000	20%	$700,000,000	$200,000,000
	$5,000,000,000	24%	$1,200,000,000	$240,000,000

Liquidity Options

Overview

Financial liquidity products are designed to provide moneys either (i) to bridge the "normal" time between an event and when the FHCF could execute a post-event financing (approximately three months); or (ii) to protect against the scenario where the FHCF could not access the markets for its full obligation for an extended period of time due to market turmoil and/or the large size of the borrowing needs of the FHCF. As discussed earlier, the resources currently available to the FHCF provide sufficient protection against (i) so it is the evaluation of products that could accomplish (ii) that has

been our focus. These products should meet the cost, executability, and capacity criteria discussed earlier, and ideally would also provide:

(1) A contingent trigger, whereby they could not be accessed until losses reached a certain level; such a trigger could reduce costs significantly and would target the use of such products to the layer where the FHCF felt that post-event financing certainty needed to be bolstered; and

(2) An ability to serve as post-event debt as well; such a feature would reduce the FHCF's reliance on bonding post-event, since no "take-out" of the liquidity instrument would be required. A fixed rate tax-exempt instrument would serve this role best, for cost and assessment management reasons.

(3) A term that can be tied to the expiration of the TICL layer in 2010 – if the TICL layer is not renewed in 2010, the FHCF may have no further need for bonding shortfall protection; therefore, if an instrument purchased now has the flexibility to expire under such circumstances, long-term costs to the FHCF, and therefore to Florida policyholders, could be reduced.

Liquidity Products

There are two broad categories of traditional options available to the FHCF for securing pre-event liquidity and several sub-categories. We will call the two main categories (1) *Pre-funded arrangements* and (2) *Stand-by arrangements*. The difference is simply that the pre-funded arrangements provide the FHCF with cash in hand before it is actually needed to pay claims. Access to that cash and the terms are therefore known with certainty. The FHCF's two series of outstanding pre-event debt[8] are examples of such financing.[9] The idea behind these pre-funded programs is that the investment income on the proceeds offsets the interest cost on the bonds, thereby creating a very low-cost financing mechanism. This notion works best when the pre-event financing can be structured as variable rate debt, so that the tenor of the investment and the debt can be closely matched. Stand-by arrangements, on the other hand, give the FHCF the right to access cash from a third-party when needed on terms generally agreed upon in advance. A **bank line of credit ("LOC")** is the most common example of this type of arrangement. There are no proceeds drawn down on these instruments until they are needed, so no investment income is available to offset the costs of the program; on the other hand, there are no ongoing interest costs to offset, and investment risk is eliminated.[10] There is limited capacity – no more than $1 billion – for a FHCF bank LOC given the current state of the financial markets.

[8] The $2,800,000,000 Extendible Floating Rate Notes, Series 2006B and the $3,500,000,000 Floating Rate Notes, Series 2007A.

[9] Private insurance companies often do similar structures under the name of Contingent Notes or Contingent Surplus Notes, which involve an off-balance sheet arrangement to accomplish liquidity financing; the FHCF gains no advantage from this structure, and can issue its pre-event notes directly.

[10] A variation on the traditional bank LOC is a contingent LOC, which reduces upfront cost by allowing draws only after an event of a certain size. This type of LOC has been implemented for private insurance companies, and may have applicability for the FHCF; however, the capacity for such a product is very limited.

The FHCF has evaluated various options under each category of traditional liquidity products in depth over the past two years, and successfully implemented two separate financings totaling $6.3 billion. For a complete discussion of the traditional products available, see two reports by the SBA: *"Florida Hurricane Catastrophe Fund: Liquidity and Risk Transfer Considerations,"* June 11, 2007 and *"Florida Hurricane Catastrophe Fund: Pre-event Funding Status and Options,"* July 13, 2007.

For the analysis this year, the situation is markedly different. First, the goal is not purely liquidity, as it was in prior years, but protection against a protracted inability to bond in sufficient amounts post-event. Second, most of the products previously considered by the FHCF for traditional liquidity, which in most cases could also provide bonding shortfall protection, are either no longer viable or have significantly higher costs and lower capacity as a result of the dramatic reshaping of the financial market landscape that has occurred in the past year. Such products as **floating rate notes, auction rate securities, variable rate demand obligations, and extendible notes** all fall into this category for one reason or another.

Another type of debt obligation that was considered for the first time this year (at least for pre-event purposes) was the issuance of **fixed rate debt, either in tax-exempt or taxable mode.** Fixed rate debt was previously not considered for pre-event purposes because of the reinvestment risk that would either (i) expose the FHCF to potentially large amounts of negative arbitrage; or (ii) expose the FHCF to mark-to-market and principal loss risk at the time of liquidation in order to pay claims. This year, however, with most of the variable rate options suffering from low capacity, high costs, or lack of market viability, and with the new goal of having debt in place pre-event that could also function as post-event debt (thereby reducing post-event bonding needs), fixed rate options are worth considering.

On the fixed rate side, the use of tax-exempt debt – which would have the best transferability to a post-event function because of its low long-term cost – appears not to be viable because of the specific conditions under Federal tax law pursuant to which the FHCF can issue tax-exempt debt. According to the FHCF's bond counsel, these provisions are restrictive enough that they eliminate for all practical purposes the FHCF's ability to use tax-exempt debt for liquidity pre-event.[11]

Fixed rate taxable debt issued pre-event is available in decent capacity (approximately $2 billion, according to the senior manager team of the FHCF), but subjects the FHCF to the reinvestment risks described above. It is certainly less expensive than the risk transfer options discussed earlier, but more expensive and less efficient than previous liquidity programs implemented by the FHCF.

The one option that appears to fit the needs of the FHCF in most major respects – large capacity, targeted to the area where post-event capacity needs bolstering, triggered only if needed, no superfluous and expensive risk transfer – is the **purchase of an option**

[11] Discussion with Nabors, Giblin & Nickerson, P.A., Bond Counsel to the FHCF, May 29, 2008.

that would allow the FHCF to put, or sell, tax-exempt fixed rate bonds to a third party after an event that produces losses to the FHCF of a predetermined amount. The option would give the FHCF the right to sell, and the counterparty the obligation to purchase, such bonds at a rate and amortization schedule agreed upon in advance. The FHCF considered purchasing such an option last year, but elected to pursue traditional liquidity financing instead via the issuance of floating rate notes.

The table below summarizes the primary available liquidity options and their approximate costs and capacities. The cost and capacity estimates for the put option structure assume that it attaches at the bottom of the TICL layer, which has approximately a 3.1% chance of being reached.

Primary Liquidity Product Options Summary

Product	Capacity	Estimated Annual Cost (%)	Estimated Annual Cost ($)	Annual Cost/billion of capacity ($)
Tax-exempt Bond Put Option	$5,000,000,000	4.50%	$225,000,000	$45,000,000
Taxable Fixed Rate Bonds	$2,000,000,000	3.50%	$70,000,000	$35,000,000

Product Discussion Summary

The options available to the FHCF to bolster its funding certainty are more limited and more expensive than they have been in the past, both because of the turmoil in the financial markets and because of the large size of the FHCF's needs. To put this in perspective, if the FHCF were to seek to assure funding certainty for the entire TICL layer via the use of the primary products available in large capacity – reinsurance and the put option – it could face costs of approximately $1.7 billion.[12] The entire premium the FHCF is estimated to charge for the TICL layer this year is approximately $250 million. Therefore, the purchase of these products in large amounts could either cause rates to go up significantly for the FHCF's participating insurers, or deplete up to half of the expected cash balance of the fund.

If these products are purchased in more limited amounts, this financial impact would be lessened, but a higher level of funding uncertainty would remain. The funding certainty achieved by a partial purchase would be in an area where the risk of loss was between 2% and 3%. The cost of achieving funding certainty in this area would be at least $225 million – equal to almost the entire amount of the TICL layer premium - given the options available. Economic trade-offs of this type are inescapable for the FHCF.

If the costs of purchasing funding certainty enhancement are deemed too high, given (i) that they protect in a layer that has just over a 3% chance of being accessed at

[12] This amount could be slightly lower if cost savings were realized by increasing the attachment point on one of the products used in order to cover the whole TICL layer.

all, and (ii) that the payout pattern for the FHCF after a large event may provide additional time for further bonding capacity to develop after the initial issuance, the FHCF may decide to forego such a purchase this year. However, in this case, funding uncertainty will remain relatively high.

Conclusion

The FHCF enters the 2008 hurricane season with its strongest cash position ever, and the ability to access the bond market post event for a significant amount of additional claims-paying capacity. However, it also has its highest potential liability ever, and faces the prospects of entering global financial markets that have been exceptionally volatile and fragile over the past year. For these reasons, it is prudent for the FHCF to consider bolstering its post-event funding certainty via the use of various financial products.

Within the categories of risk transfer products, the product that best addresses the FHCF's needs is traditional reinsurance; however, the costs of this product are relatively high compared to the primary liquidity options available. The reason for this cost differential – the fact that risk is transferred away from the FHCF via the purchase of reinsurance – has benefits to the FHCF beyond simply providing post-event funding certainty, but these benefits must be carefully weighed in light of the costs to policyholders and the increased chance of assessment from smaller storms that could result from this purchase. A useful rule of thumb given the size of the FHCF's assessment base is that each $1 billion of risk transfer purchased (and losses avoided) would reduce the required assessment percentage by approximately .2% annually. Therefore the purchase of the entire $5 billion layer of reinsurance could reduce the assessment percentage after a large storm by approximately 1% per year. However, the chances of hurricane losses of the magnitude necessary to reap this benefit occurring are less than 2%.

In the liquidity products category, the one product that stands out as meeting the FHCF needs is the tax-exempt bond put option. This product has large capacity, provides post-event funding certainty for a large portion of the TICL layer, and should be easily executable. While the costs of this product are significantly higher than they were a year ago, it is competitive to most other liquidity options that provide inferior benefits, and significantly less expensive than reinsurance.

The chart below summarizes these categories and options:

FHCF - Product Options ------ 2008		
	Liquidity Products	**Risk Transfer**
Pros:	Relatively cost-effective Targeted to solve problem at hand	Transfers risk out of FL Reduces assessments in large storm
Cons:	Costs have gone up significantly since last year Some execution risk	Expensive Not targeted to the issue (funding certainty) at hand
Best Option:	Put Option: Enables FHCF to sell bonds on predetermined terms (amount, rate, & amortization) after an	Traditional Reinsurance: Contractual agreement to transfer predetermined loss layers to a third party after an event
Capacity:	$5 billion[1]	$5 billion[1]
Annual Cost:	Approximately $225 million	Approximately $1.2 billion

[1] *Source:* Relevant FHCF Financial Services Team Members.

The principal options available to the FHCF given this situation are:

(1) No purchase – this option would have the highest funding uncertainty, but preserve FHCF financial resources.

(2) Purchase both products to cover as much of TICL layer as possible – this option would have the highest cost (up to $1.7 billion) but would provide the greatest funding certainty.

(3) Purchase the put option – this provides targeted funding certainty at the lowest available cost for capacity.

(4) Purchase reinsurance – this option provides risk transfer and assessment reduction after a large event, but at a higher cost than the put option.

The FHCF could also choose to purchase either option in smaller amounts than the maximum capacity shown, or to purchase some of each product.

We look forward to working with the FHCF as it evaluates its options and implements a strategy.