More Protection at Lower Cost to Consumers

Leveraging a Stronger Public-Private Partnership

How to Create a State Catastrophe Fund

ProtectingAmerica.org has worked with legislators throughout the country to draft legislation which would create State Catastrophe Funds. The bills are based on the Model Act adopted by the National Conference of Insurance Legislators (NCOIL) and the long-term success of the Florida Hurricane Catastrophe Fund, which has saved the Florida market from complete collapse, saved homeowners billions of dollars off their homeowners insurance bills compared to what the private reinsurance marketplace would have charged, and stimulated valuable prevention and mitigation efforts.

The premiums charged for catastrophe protection in a public sector catastrophe fund under this model would be both actuarially sound and significantly lower than those charged by reinsurers in the private market. Depending on the layer of coverage and probability of occurrence, we have found the cost of reinsurance in the private market will generally be three to five times the cost of the same coverage through a quasi-public sector entity, and there are examples where the cost is ten times as much.

The primary reasons State Catastrophe Funds are less expensive than coverage in the private reinsurance market include:

- The operating costs of a State Catastrophe Fund can be as low as 1% of the annual premium compared with the operating costs of private reinsurance, which can range between 10% to 15% of the premium collected;
- A State Catastrophe Fund would charge only the average cost of the coverage plus a small expense load, while a private reinsurer will charge the average cost of the coverage plus a more significant expense load and a significant profit and risk load;
- A State Catastrophe Fund does not typically pay reinsurance brokerage commissions;
- A State Catastrophe Fund has no underwriting costs since it is a mandatory program requiring a minimum level of participation by all insurers that sell residential property insurance in a state;
- Since a State Catastrophe Fund is a program that benefits citizens of a state, it does not pay federal or state taxes; and
- A properly structured State Catastrophe Fund has the ability to issue tax exempt debt, which will result in lower financing costs should the need arise to finance losses with revenue bonds.

In short, State Catastrophe Funds work because they help contain the cost of residential property insurance, protect against large private reinsurance premium increases, stabilize the market and encourage competition among homeowner's insurance companies.

Getting Started

The creation of a State Catastrophe Fund is not extremely complicated. The enabling legislation sets forth the powers, responsibilities, and coverage parameters of the Fund and participating insurers. After an initial contribution from the state (the IRS requires a contribution to secure tax-free build-up in the funds), the Fund operates 100% on private insurance company premiums. The initial state appropriation, as well as initial assessments against each insurance company (as stated in the enabling legislation), provide the cash flow for the new Catastrophe Fund to secure the necessary professional employees, appropriate consultants (CPAs, actuaries, attorneys, underwriters, etc.) as well as office space and equipment. Given the limited role of the Fund, there is no need for an extensive and elaborate administrative set-up. For example, the Florida Hurricane Catastrophe Fund currently operates with a full-time staff of just nine people, despite providing coverage for over $28 billion of potential losses. The Fund can be up and running in a matter of weeks, and could issue contracts and begin collecting premiums from insurers shortly after that time, with cost savings immediately provided to consumers once the contracts are effective.

Who operates the Catastrophe Fund?

Depending on the state, the draft legislation recommends, that the Catastrophe Fund come under the jurisdiction of a State Treasurer working in conjunction with the State Insurance Commissioner, and in some cases, with a State Controller or Comptroller. The draft legislation also recommends the creation of an Advisory Council with appointments from the Governor, with the advice and consent of the Senate. Appointments to the Advisory Council should include an actuary, meteorologist, engineer, a representative of an insurer, an insurance agent, a representative of a reinsurer, consumer representative, representative of organized labor, representative of law enforcement, representative of firefighters, a building code official, representative of the State's emergency management office and one or more members of the public.

Structure of a State Catastrophe Fund

The Fund is set up as a state trust under the control of designated commission members. Funds in the trust grow tax-free and are only utilized when insured losses in a single year reach a catastrophic trigger that will vary depending on a particular state's overall exposure and caps the liability of the Fund; again at a level that will be set based on particular circumstances in each State. The goal of the Fund is not to displace the private reinsurance market in the State. Rather, the goal is to provide a more cost-effective source for additional capacity for a particular layer of exposure that will stabilize the overall market and provide savings for homeowners. Although an insurer can select

their level of coverage, all residential property insurers must participate in the Fund and pay premiums to the Fund based on their risk-adjusted exposure.

State Catastrophe Fund Coverage

In a marketplace with no Catastrophe Fund, the premium paid by homeowners to the primary insurer includes the entire cost for any private reinsurance purchased by the primary insurer. In the event of a catastrophe, insureds pay a deductible of typically one or two percent (although the trend is for higher deductibles). The primary insurer pays for all losses to the consumer above the deductible. The primary insurers then receive reimbursement up to the reinsured limit from the reinsurer.

Table 1

Reinsurer
Primary Insurer
Insured's Deductible

With a State Cat Fund in place, once the insured losses reach the catastrophic trigger, the State Cat Fund would cover 45%, 75% or 90% of the losses up to the Cat Fund cap (losses currently being covered by the primary insurer or reinsurer at a much higher cost).

Table 2

National Catastrophe Fund or Reinsurer	
Primary Insurer (10%, 25%, 55%)	State Cat Fund
Primary Insurer	
Insured's	

Deductible

Premiums

With a State Catastrophe Fund, insurance companies selling homeowner's insurance coverage are charged an annual premium by the State Catastrophe Fund based on actuarially sound rates. The rates are applied by zip code, construction type and deductible level. In order to calculate the correct premium, each insurer must submit to the Fund its exposure data by a certain date each year. It is important to note that reinsurance companies demand this same type of information before writing reinsurance coverage. A key difference is that when an insurance company writes a check for the reinsurance premium to the State Catastrophe Fund, it is dramatically less expensive than compared to the private marketplace. Another key difference is this: if no catastrophe occurs in a given year, the moneys paid into the State Catastrophe Fund stay in the Fund and grow over time. Under the status quo model, the money flows primarily off-shore to the investors of private reinsurers.

Coverage Options

Every homeowner's insurer must participate in the State Cat Fund, but companies have a choice of the level of participation. Each company may choose a participation level of 10%, 25% or 55%. Simply put, if a company wants to assume a greater portion of their catastrophic loss exposure, they can do so by choosing the 55% participation option (they would then retain 55% of the risk). As illustrated in Table 2, each primary insurer chooses to retain between 10% and 55% of the State Catastrophe Fund layer of coverage.

Covered Lines

The dwellings eligible for coverage under a State Catastrophe Fund are flexible. Residential properties are the most exposed and bear the highest reinsurance costs. ProtectingAmerica.org supports including homeowners, rental, condo owners and mobile homeowners policies in the Catastrophe Fund.

Capacity

Insurers are charged an actuarially sound premium for the coverage they choose, and this premium becomes the basis of the Fund balance. As money is collected, it is set aside and permitted to grow and accumulate tax-free. ProtectingAmerica.org supports legislation that requires the Fund to distribute between 10% to 35% of the investment income earned each year back to first responders, counties and municipalities, and other programs that provide prevention, mitigation, disaster preparation and consumer education.

Is a State Catastrophe Fund like Citizens or a FAIR Plan?

Absolutely not. A Catastrophe Fund relationship is NOT a relationship between consumers and insurance companies (like a FAIR Plan, Citizens, or traditional insurance company-customer relationship). The transaction is between the insurance company and the State Catastrophe Fund.

A FAIR plan, or similar plan, is a state-run "insurer of last resort" that writes policies for consumers who cannot obtain coverage from a traditional provider. State Catastrophe Funds function entirely as a financial backstop that is funded by insurer contributions.

What happens to the Fund if a catastrophe DOES NOT occur in a given year?

Of course, this is what we all hope for. If an event does not occur, the money in the Fund continues to grow along with new premiums. A portion of the investment income (10-35%) would be distributed each year for the prevention, mitigation, preparation and education programs. In states without a State Catastrophe Fund, those same premiums become part of profits for private investors a majority of which typically flows out of the United States to foreign reinsurers.

What happens to the Fund if a catastrophe DOES occur before the fund builds up completely?

In the event of a deficit, the Fund has the authority to issue bonds and to levy assessments on property and casualty premiums to provide a revenue stream to pay off the bonds. Assessments are usually capped at a given percentage. Even with a possible bonding and/or assessment due to an event, consumers are still far better protected with a State Catastrophe Fund when compared to historic reinsurance company post-event premium increases. According to Guy Carpenter and Associates, the United State reinsurance industry raised premiums by an average of 76% to cover their losses in 2005. Who pays this cost? Consumers. Moreover, and critically important, the market is protected from collapse because there is certainty that the State Catastrophe Fund will be there to continue to provide protection after a major event. Under the status quo model, there is no certainty as to whether private reinsurers will continue to offer coverage, the limitation of that coverage or the price of it.