FLORIDA’S INSURANCE NIGHTMARE

BY PAIGE ST. JOHN
Shaky property insurers put millions of Floridians at risk

COMMERCIAL PROPERTY INSURERS WERE shut down in Florida and the states of Texas and Mississippi in the aftermath of the 2004-05 hurricane season. The state's insurance commissioner ordered 36 companies in Florida to stop writing new policies.

Starting with Hurricane Andrew in 1992, hurricanes have taken a toll on property insurers in Florida, leading to a large number of failures and nonperforming companies — of the 1994-95 season, 115 insurers failed at least once. Of the 2004-05 season, 45 insurers failed at least once. Florida's insurance commissioner estimated that the two seasons cost insurers $16 billion, and blamed much of the failure on Florida's weak property-insurance market.

The Herald-Tribune spent more than a year examining potential causes for the failure of property insurers in Florida. It found a number of factors that contributed to the problem:

- Florida's insurance commissioner, which is the agency responsible for regulating the property-insurance business, did not have the power to shut down insurers who were losing money.
- Florida had no laws that would enable the state to force insurers to raise rates, even if they were losing money.
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The Herald-Tribune found that Florida's insurance commission...
By PAIGE ST. JOHN, paige.stjohn@heraldtribune.com

Millions of Floridians now bet their homes on property insurers that teeter on the edge of financial failure, a Herald-Tribune investigation has found.

These companies look nothing like the Allstates and State Farms that insure the rest of America — legacy carriers that command bankrolls the size of small nations.

Instead, because State Farm and Allstate are fleeing Florida, a growing number of homeowners get their insurance from tiny, untested companies that have a few million dollars in the bank but insure billions worth of property they could never hope to rebuild on their own.

No one knows what will happen when the next big storm strikes Florida shores. But the signs are not promising.

Over the past year, without having to weather a single hurricane, Florida led the nation with a half-dozen property insurance failures. For the first time, state regulators openly warn that more failures will come, even if a storm does not.

The Herald-Tribune spent more than a year examining Florida’s property insurers, tracing the ownership of more than 70 companies through shell corporations and reviewing the financial filings of each. It found:

- One in three privately insured Florida homeowners relies on insurers that exhibit one or more signs of financial risk.
- More than 100,000 homeowners relied on companies barely capable of paying for house fires, let alone hurricanes. These insurers’ reserves come so close to the state’s $4 million minimum requirement that they operate with only a few hundred thousand dollars of their own to pay claims.
- During the 2009 hurricane season, at least 38,000 Florida homes were insured by companies state regulators knew would fail. Homeowners were not told until after hurricane season, when one company was shut down and the other had to sell.
- Lawmakers and regulators have ignored warnings and encouraged private companies to stretch their limited cash further. They have pushed companies to insure more and more homes without increasing the money set aside to pay claims, a practice that likely to happen.

See INSURANCE on 11A

**FLORIDA’S INSURANCE NIGHTMARE**

This is the first part in a yearlong Herald-Tribune investigation of Florida’s precarious property insurance system.

**INSIDE**

- How risky is your insurer? 13A
- How the Herald-Tribune measured insurer risk. 13A
- How to pick a strong insurance company. 12A

**ONLINE:** Detailed financial measures for more than 50 Florida insurers at heraldtribune.com/Floridainsurance.

**COMING SOON:** Dozens of Florida insurers are making themselves rich instead of protecting policyholders.
In 1992, these concentrated risk-takers insured just 6 percent of Florida. Today, including the Flori-da-only subsidiaries of national insurers, they cover 71 percent. The companies — historically, and in the past — have been an industry built on huge re- serves. Firms amass a foundation of capital, then risk money by promising to repay homeowners if a big event occurs. Profits, historically, came from the interest earned on the money that sits in reserve to be paid out.

All that has changed. In Florida, insurers are now risk-brokers, players with relatively little money left to build reserves. Reinsurance enables fast growth. Instead of building up a company slowly by amassing surplus to write more policies, new insurers can pledge a portion of future premiums and instantly take on thousands more customers and billions more dollars in hurricane risk.

The formula has helped springboard start-up insurers into multi-billion-dollar enterprises in months. But it has crashed others as quickly as it has nurturing Florida homeowners at risk.

Even in 2000, before the exodus of single-state carriers in Flori-da, A.M. Best, the nation’s oldest financial rating company, issued a report warning that the state was growing companies without the financial depth to survive a single hurricane, let alone the state’s average of 2.5 a year.

It accused Florida, paying these new companies to assume policies from the state insurance pool, of handing the riskiest properties to the least capitalized opportunistic insurers.

The exposure of these two insur- ers during the 2009 hurricane season was twice that even of Citi- group’s HomeWise Property Insurance, the state- run company that covers homes owned by the elderly by offering a safety-risk by other insurers. Six other Florida carriers are in the same boat, carrying greater concentrations of risk in Miami than Citizens does.

“I think, in the next storm we come, I fear it if lands anywhere near here,” said Dulce Suarez-Kenzick, a Miami agent who is past president of the Latin American Association of Insur- ance Agencies.

While Northern Capital Select is the highest concentration of risk in Florida, it also had the least amount of money. Northern Capital Select’s financial statements and reinsurance contracts show that in 2009 it was operating with barely a $300,000 cushion above what it needed to meet state solvency requirements — not even enough to cover a handful of house fires.

The larger Northern Capital Select had greater assets, but also more risk, leaving it at the start of 2009 just above what state laws re- quired insurance to have for exposure.

The problems started when the company was formed. Under the old business model of property in- surance, the Northern Capital Selects probably would have needed more than $130 million set aside to meet state requirements for the value of homes they insured in Florida.

The company did it with less than $20 million.

In 2008, it bridged the gap by buying huge amounts of rein- surance from overseas investors willing to gamble against a storm. According to third-quarter finan- cial statements, the carriers by September 2009 spent $64 million of the $94 million in premium they collected to buy that protection.

Between what the insurers paid for reinsurance and what they paid in other overhead costs, contracting with re-insurers, there was not enough money left to pay the claims.

The constant losses destroyed reserves. By last September, Northern Capital Select barely met the state solvency require- ments.

But regulators did not warn con- sumers about the risk.

Instead, the agency in August secretly prepared an order plac- ing the company under adminis- trative supervision.

While Northern Capital basked in the glow of its Inc. Magazine publicity and hit the financial mar- kets with more than $2 million, OIR sought to require the company to buy more reinsurance and stop selling new business in Mi- ami-Dade, Broward and Palm Beach counties.

An unsigned copy of the con- fidential order was obtained by the Herald-Tribune. OIR officials re- fused to acknowledge its exist- ence. All that Northern Capital’s owners were not returned. President Wayne Fletcher and other company officials did not respond to repeated calls.

Meanwhile, Northern Capital began retrenching, merging its two insurers into one. In Febru- ary, for a bare $42 million, the re- ceived an “exceptional” financial rating from Demco, the rating agen- cy is as follows: 12A credit rating, and cash up with a new business plan passed unmet.

The company remains in busi- ness.

In the RED ZONE: 42 INSURERS AND RISK

The financial troubles of Flori- da insurers go far beyond North- ern Capital. Six companies have failed or been forced to sell in the past year. Florida regulators say more are on the verge of collapse, but will not name the companies or say how many are in trouble.

In the absence of public disclo- sure, the Herald-Tribune turned to measures commonly used by those in the industry, from agents who place your policy to regula- tors who police the business, to ac- ademics and consumer advo- cates.

A half-dozen experts consulted by the Herald-Tribune cautioned that no single measure told the story of an insurer.

They agreed, however, that there are several important indica- tors of financial weakness and they provided benchmarks for each. They include: levels of savings, comparatively high concentrations of risk, an over-reliance on reinsurance and a heavy concentration of customers in one geographical area. The Herald-Tribune found that about 30 companies out of more than 70 reviewed appear financially sound. Forty-two failed at least one of the benchmarks.

That means one in three private- ly insured homes in Florida some 2 million families — relies upon an risk-insurer for hurri- cane protection.

Fourteen of those insurers tripped two or more of the four warning flags. Of the three com- panies that failed at least three tests, two of them, Edison and Northern Capital Select, were being shut down or sold by January.

In December, Aon Benfield, one of the the world’s largest in- surance brokers, questioned if the Florida insurance market is, in its words, “at the tipping point.”

In a report to its insurance com- pany clients, the brokerage esti- mated that one in 10 Florida car- riers has insufficient capital to weather a catastrophe. Not one of the 51 national property insurers reviewed by Aon had the same risk profile.

Bryn Ehrhart, CEO of Aon An- alytics in Chicago, said, “Florida is operating at a much higher lever- age rate than the rest of the na- tion.”

See INSURANCE on 12A
Shaky insurers put millions in Florida at risk

INSURANCE from 1A

WHAT HAPPENS IF YOUR INSURER FAILS

After eight hurricanes swept through Florida in 2004 and 2005, five insurance companies failed. Some 58,000 homeowners across the state were pushed into the state’s bailout program, the Flori- da Insurance Guaranty Association.

Aside from the nearly 900 million bill presented to Florida consumers to cover those checks, “It is not a bad place to land,” said PGA Operations Manager Tom Streucker.

That is not always the case. More than five years after Hurricane Ivan struck the Panhandle, Pensacola lawyer Charles Beall is still trying to force the solvency fund to compensate those who lost four homes in the storm.

Two of Beall’s clients have received low offers, but he said the other two have yet to get even a check. “They are from a strong fund. One is unable to rebuild. Her unlivable, damaged town house has not been repaired and empty amid rows of rebuilt homes.”

Beall’s hands are largely tied. The fund cannot be sued for acting in bad faith. The lawyer cannot even collect his legal fees unless he can persuade the fund to at least give him and his clients a denial.

“It’s the ultimate insult when the state company set up to protect you ignores you,” Beall said. “They ought to be thrown in jail just for causing indiscouragement.”

Even if the program worked perfectly as a backup, it would not have enough money to cover everyone if a large enough wave of insurance failures struck after a hurricane.

The 2004-05 hurricanes pushed the solvency fund to its financial limits in 2006. EXECUTIVES acknowledge that the program would have difficulty raising money fast enough to make timely payment of claims for much larger involvements. The result would be homeowners receiving only partial payment, then waiting months, if not years, for the rest.

Streucker considers a disaster of that scale unlikely. “It is pretty much a doomsday scenario,” he said.

But a “doomsday scenario” may not be all that unlikely, according to Aon’s estimate of the number of Florida insurers at risk.

According to the broker’s report, 18 percent of Florida insurers have “significant inadequacies” in their capital — placing $84 billion worth of homes at risk of being un- covered in a catastrophe. That is one and a half times the size of the program that failed following the 2004-05 hurricanes.

BILLOINS IN POLICIES FROM KEY BISCAYNE HOME

When Magnolia Insurance was approved to start insuring Florida homes in 2008 it had no office, no outside agents, and a lot of debt.

The carrier, opened by a Key Biscayne insurance agent working with a $24 million million, did not even have an active insurance license when Florida regulators agreed in April 2008 to allow it to take as many as 60,000 policies to be sold by the Citizens Property Insur- ance. By mid-2008, thousands of Florida homeowners were getting letters announcing that unless they objected, Magnolia was their new carrier.

Miami insurance agents working on behalf of homeowners to check on the obscure newcomer had little more than a Texas Post Office Box to guide them.

“They didn’t even have an of- fice. They didn’t even have a Web site. They didn’t even have a phone,” said Dulce Suarez-Renick, the South Florida insurance agent.

“You couldn’t even help your customer get a copy of their new policy.”

When she did locate Magnolia, it was at an unlikely place — the personal residence of its founder. “They were working out of his home in Key Biscayne,” Suarez-Renick said. “We knew from Day One Magnolia was not going to make it.”

Just 20 months later, the same Florida regulators who helped put Magnolia into business put it under administrative supervi- sion and ordered its president to leave.

The December order capped what is possibly the shortest start- to-suspension of a Florida insurer company.

Florida agents wonder how the company got licensed in the first place.

State incorporation records for Magnolia list its Key Biscayne business address as a roadside room-ten of- ticle home of compa- ny president Henry Kimball. Those records show Florida law allows state regula- tors to deny an insurance license to a company whose executives show poor financial credibility.

Fla. law also provides that the Office of Insurance Re- polition cleared Irl, despite the fact that Miami-Dade County Circuit Court files show he had a history of bad credit card debt.

“Did you have your Florida permit to get approved to run an insurance company in the state?” asked Suarez-Renick.

Officials with Florida’s Office of Insurance Information refused to answer questions about Magnolia, including wheth- er Irl had disclosed his personal fi- nancial problems. Irl did not re- spond to messages left with his company or at his home.

Circumstances surrounding Magnolia’s supervision remain sealed under Florida insurance laws that treat regulatory investi- gations as confidential, leaving more than 80,000 policyholders in the dark as they must decide whether to renew.

Though company executives and their consultants met with state regulators in November, Magnolia operations shut down in the 2009 hurricane season with no outward sign of trouble.

The only specific information about why Magnolia’s operations were seized comes from Irl. At Magnolia tech, the financial rating firm that suspended Magnolia’s “A Excep- tional” rating two weeks before regulators stepped in.

In the rating suspension, De- motex explained for the first time that it had been negotiating with Magnolia for more than a year on serious problems with its financing, which it termed “critical.”

Florida Officials Ask: What Choice Is There?

The Office of Insurance Regula- tion is in the throes of dramatic change

From Kevin McCarthy, insurance commissioner, to the lowest- level regulators, OIR officials ex- pressed optimism for the market as a whole despite trepidation over the stability of individual in- surers.

“You’re right. There will be fail- ures,” said Rob Westcott, sol- vency director for OIR’s property division. However, she and other regulators said, they believe most of Florida’s relatively new insur- ers will survive and a large por- tion will go far.

These officials argue the fail- ures are a natural byproduct of the state’s strategy to attract new carriers quickly as national carriers real- ly began hundreds of thousands of customers after 2005.

Florida had to convince inves- tors, entrepreneurs and others to get into the insurance business and assume tens of thousands of policies almost overnight.

The state has, since 2006, at- tracted 29 new companies with $509 million in new investment. “It’s not a success story that we’re able to attract new compa- nies that are writing 62,000 poli- cies,” McCarthy told Florida Cabi- net members in August.

But in the months following, McCarthy and his staff have switched their message, warning that some of those new carriers are failing and others need rate in- creases to survive.

“It is a difficult marketplace. . . . You’re getting to a point where these companies are going to sepa- rate themselves as to who can do it successfully and who can’t. And that isn’t going to,” Westcott said in November, following the shut- down of American Keystone.

“All we hear from the Legisla- ture is Free Market, Free Market,” Westcott said. “Well, this is a function of Free Market.”
In recent months, Florida property insurers have come under increased pressure ...

STAFF PHOTO /
MIKE LANG
12A Sunday, April 18, 2010   www.heraldtribune.com

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Herald-Tribune Investigation

How Regulators Put Florida Homeowners at Risk

By Paige St. John, Paige.StJohn@heraldtribune.com

For most of 2009, American Keystone was an empty promise.

The Florida company insured some 70,000 homes and condominiums worth $12 billion with just a few hundred thousand dollars in operating cash.

At the height of hurricane season, Keystone was so low on money the Florida Office of Insurance Regulation deemed it “injurious to its policyholders and to the public.” Had a hurricane arrived, thousands of Floridians would have found themselves with worthless policies.

But the state agency did not shut Keystone down. Records sealed from public view for nearly a year show regulators chose to allow Keystone customers to unknowingly gamble through an entire hurricane season.

The delay bought Florida regulators a chance to orchestrate a “soft landing” instead of an abrupt collapse and gave Keystone’s investors a chance to search for a buyer. Meanwhile, company insiders continued to pay themselves hundreds of thousands of dollars in salaries and consulting fees.

A yearlong Herald-Tribune investigation found that allowing struggling insurers to remain in business has become an alarming part of how Florida regulators cope with the state’s ongoing property insurance crisis.

Eager to replace national carriers fleeing the state and to reduce government-sponsored coverage, regulators have bet Florida’s future on companies they know are shaky. They allowed at least four insurers on the verge of failure to write policies through most of 2009, the Herald-Tribune found.

What’s more, regulators have awarded licenses to would-be insurers that had no funding, to individuals who had dubious credentials and, in the case of Keystone, to a business started by a felon banned from the industry.

In the past three years, state regulators have encouraged unproven companies to take on dangerous amounts of policies, and steered more than 200,000 homeowners into companies so weak they were already required or close to being required to improve their finances.

When these overextended insurers became unsound, Insurance Commissioner Kevin McCarty’s office took extraordinary steps to keep them open. In lieu of cash and sound investments that could be used to pay claims, regulators sometimes counted questionable assets, including IOUs, real estate and tax credits.

The Herald-Tribune found evidence of these practices in five of the seven instances in which companies fumbled last year.

See REGULATORS on 10A

Florida’s Insurance Nightmare

Some Florida insurance companies stay in business even when regulators suspect they would not be able to pay claims after a hurricane.

Inside:

Examples of struggling insurers that stayed in business. 10A

A new approach. Are regulators getting tough? 11A

Online:

The documents that show how regulators let Keystone put people at risk: heraldtribune.com/property/insurance.

Monday:

Regulators are gambling that one unorthodox insurer can overcome past violations and successfully offer discount rates.
How state regulators put tens of thousands of homeowners at risk

REGULATORS FROM 1A

The full-time job of Florida’s insurance regulators is to grant a failing insurer a public body...ultanely, they can be the difference between staying open or facing closure.

For months, Florida’s top in-...it. The full-time job of Florida’s insurance regulators is to grant a failing insurer a public body’s permission to operate.

As a result, Keystone —...he law, Keystone continued to accept homeowners’ renewal checks, a source of income from which it had been...the insurance company.

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How regulators put homeowners at risk in Florida

REGULATORS from 10A
in internal correspondence that American Keystone should have been declared insolvent nearly a year earlier.

The company had survived only through what Jim Paddock, an OIR supervisor of the financial analysts handling Keystone, called a series of “creative solutions” to “prop up” the company’s paper balances. “They should not have been writing since November of 2008,” he wrote.

WHO IS PROTECTED?
Rather than recognize American Keystone as a failure, the Office of Insurance Regulation focused for months on the chance it could survive or find a buyer.

Regulators argue that strategy is best for consumers — and for Florida taxpayers.

If a struggling company finds a buyer, policyholders can keep their coverage with few noticeable differences. If no buyer is found, regulators prefer an orderly withdrawal that might allow other companies to assume at least some policies by the failing insurer.

Secrecy is key. “The minute you tell everybody this is going down the tubes, the book (of business) is gone, and there’s nothing to sell,” Westcott said.

The worst outcome, regulators say, is an immediate shutdown that dumps policyholders into already stretched government insurance programs. “It’s our job to say how can this be best accomplished in the marketplace that is least disruptive to the policyholder,” Westcott said.

In the case of Keystone, regulators said, they believed the company had a chance to find a buyer. And it was easier to have a slow shutdown with the company’s cooperation than a quick one against the company’s will, Miller said.

In fact, she contends the legal hurdle to shut down a company is so high it is nearly impossible to force an insurer to close against its will. As a result, companies like Keystone are given time to wind down if they sign settlement agreements that require them to close.

“To say we keep the company in business is not a fair characterization,” Miller said. “We were putting them in a position to take policies out. We were taking it apart at that point.”

Even so, Miller said her office has been taking more aggressive oversight in recent months because so many owners are draining capital out of their insurance companies.

She said the agency is reviewing companies’ financial arrangements more closely and is more apt to order owners to infuse cash into flagging companies.

She also said the OIR is no longer willing to divert large numbers of homeowners covered by Citizens into new insurance companies, a practice that helped some questionable companies instantly generate business.
MINIMALISM 

By LLOYD DUNKELBERGER

The payments to themselves, by and large, haven't lost any money. In fact, some insurers have made a lot of money.

The Florida insurance industry, managed well, you can stand out was how much United paid itself, though the traditional way of figuring revenue — the great amount of premium.
By PAIGE ST. JOHN, paige.stjohn@heraldtribune.com

Today, nearly half of Florida’s home insurance is provided by companies whose primary profit comes not from insuring homes but from diverting premiums into a host of side ventures.

Investors and executives in 2008 moved $9 billion in policyholder money out of heavily regulated insurers, where profits are capped and dividends are restricted, to separate companies that are owned by the same people, housed at the same address and sometimes use the same employees.

As soon as the money is moved, it is beyond the reach of homeowners who might need it to rebuild after a disaster.

It is also free to be paid to investors and owners as profit without interference from regulators.

Meanwhile, insurance executives complained about losses and state-mandated discounts, and pressured state regulators for permission to charge homeowners more — even to end rate regulation altogether.

The payments to themselves, by and large, were legal.

As Allstate and State Farm have fled the state and left homeowners scrambling for coverage, Florida lawmakers have intentionally relaxed rules designed to police insurance company profits. Regulators hoped the promise of profits would persuade investors to start more insurance companies.

The Herald-Tribune spent more than a year investigating the Florida insurance industry, including reviewing the financial filings of more than 70 Florida-only companies that now provide nearly three-quarters of the private property insurance in the state.

It found that:

- Overhead costs — expenses not related to hurricanes or other disasters — are 50 percent higher in Florida than the national average. The higher overhead cost Florida homeowners an added $900 million in 2009 alone.

- In cases where the Herald-Tribune could see both sides of the ledger, the overhead charges were inflated. Of the $72 million in management fees that Southern Oak paid its affiliate over five years, nearly half — $35 million — was profit, insurance regulators now say. Three other carriers paid themselves an average 44 percent profit.

- Some insurers devote so much of their premium to reinsurance and paying related companies they have little left for claims. Even in its first months of operation, state financial examiners said, American Keystone was structured to spend more than it collected.

- Insurers have contracted so much of their work to unregulated sister companies that some are essentially shell operations with few employees. Homeowners’ Choice, for instance, pays one affiliate to negotiate reinsurance contracts and another to manage policies, and buys catastrophe protection from a third.

- Lax state rules encourage executives to pay sister companies as much as possible. The Legislature barred regulators from requiring insurance affiliates to report their finances.

- Even while complaining of losses, Florida insurers from 2006 through 2008 paid $38 million in bonuses.

See INSURANCE on 10A
How the insurers are able to make millions on the side

INSURANCE from A

Most of the $2 million in other perks from 710 insurers — 180 of their competitors in the state — Florida's insurer chief trade group, the Florida Council of Insurance, defends internal deals as a way to provide incentives to the state's start-up insurance companies. Regulators bar insurance companies themselves from making gifts to investors unless they have been in business at least three years.

"Investors would simply not be putting up money with a risk of another Great Depression," said Edward D. Miller, vice president of the council. Others say self-dealing incentives are a hidden plus for those companies.

"The companies are taking profits out as opposed to keeping them in for future losses," said Frank C. Chafin, deputy CEO of the council, a New Jersey company that sometimes audits insurers' books for private investors. "When the insurance company fails, they have no claims left. In fact, they've made a lot of money."

HOW INSURERS GUARANTEE PROFITS

The insurers move money from one area to another in a variety of ways, according to the Florida Financial Solvency Regulation, a New Jersey company that tested the insurance industry.

One way insurers move money is to write a number of policies for a fixed price and then sell them at a profit. A second way is to acquire businesses for more than they are worth and then sell them to other companies for a profit. A third way is to create a new business and then use a parent company to buy it back for more than it is worth.

"The companies" — insurers, in fact — are putting up money with a risk of another Great Depression," said Edward D. Miller, vice president of the Florida Council of Insurance, a New Jersey company that tests the insurance industry.

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Global twist to war on smokes

CREATING AN S82 BILLION THREAT
THE FORMULA: A WIDER RISK, FOUR HOURS AND A DUBIOUS HURRICANE COMPUTER MODEL

The creation of an S82 billion hurricane threat
**HERALD-TRIBUNE INVESTIGATION**

**CREATING AN $82 BILLION THREAT**

**THE FORMULA: A HOTEL ROOM, FOUR HOURS AND A DUBIOUS HURRICANE COMPUTER MODEL**

By PAIGE ST. JOHN, paige.stjohn@heraldtribune.com

Hurricane Katrina extracted a terrifying toll — 1,200 dead, a premier American city in ruins, and the nation in shock. Insured losses would ultimately cost the property insurance industry $40 billion.

But Katrina did not tear a hole in the financial structure of America’s property insurance system as large as the one carved scarcely six weeks later by a largely unknown company called Risk Management Solutions.

RMS, a multimillion-dollar company that helps insurers estimate hurricane losses and other risks, brought four hand-picked scientists together in a Bermuda hotel room.

There, on a Saturday in October 2005, the company gathered the justification it needed to rewrite hurricane risk. Instead of using 120 years of history to calculate the average number of storms each year, RMS used the scientists’ work as the basis for a new crystal ball, a computer model that would estimate storms for the next five years.

The change created an $82 billion gap between the money insurers had and what they needed, a hole they spent the next five years trying to fill with rate increases and policy cancellations.

RMS said the change that drove Florida property insurance bills to record highs was based on “scientific consensus.”

The reality was quite different.

Today, two of the four scientists present that day no longer support the hurricane estimates they helped generate. Neither do two other scientists involved in later revisions. One says that monkeys could do as well.

In the rush to deploy a new, higher number, they say, the industry skipped the rigors of scientific method. It ignored contradictory evidence and dissent, and created penalties for those who did not do likewise. The industry floated regulators who called the work biased, the methods ungrounded and the new

See MODELS on 14A

**FLORIDA’S INSURANCE NIGHTMARE**
This is the latest in an ongoing Herald-Tribune investigation of Florida’s property insurance system. For previous stories in the series, go online to heraldtribune.com/floridainsurance.

**INSIDE**
GRAPHIC: How badly did they miss? 14A
GRAPHIC: Are there really more hurricanes? 15A

**ONLINE** Check the financial strength of Florida property insurers and see who is writing new policies at heraldtribune.com/floridainsurance.

**COMING TOMORROW** Predicting the risk and damage from a hurricane has become a science, according to some. But many contend it remains guesswork, despite the reliance on computer programs so complex that saving them on floppy disks would require an entire warehouse.
The creation of an $82 billion hurricane threat

MODELS from a computer model illegal. Florida homeowners would have paid even more without RMS’s new model. Katrina convinced the industry that hurricanes were getting bigger and more frequent. But it was RMS that gave a nudge to the increased danger and came up with a model to justify it.

For years, RMS changes, the cost to insure a home in parts of Florida world-record level. Hundreds of thousands of homeowners were forced to find new insurers as national carriers fled the state. We could see the prediction of a more dangerous Florida than ever before. The new RMS model called for at least 11 hurricanes to come ashore in the United States by the end of 2010, a number that had not been seen since Hurricane Andrew in 1992.

RMS aimed most of that virtual increase at the Caribbean. In the end, the four scientists shared the contested belief hurricane activity is on the rise, and what might be. The impact these private models have on the insurance price homeowners pay is so great that Bob Hunter, insurance director for the Consumer Federation of America, calls them unregulated “rate bureaus.” For most of the past two decades, risk models have relied on actual hurricane activity recorded over more than 100 years to produce averages and other estimates of storm formation. But even before Katrina, RMS was under pressure to challenge the late and long-term outlook. Insurance industry statistical models to which they had no access might be more accurate. And they wanted it to forecast hurricane activity for next few years based on current conditions, not what the history would repeat itself.

The pressure came from several places. Some insurers sought validation that global warming was increasing the threat of hurricanes. Others in the industry wanted a shorter-term model to encourage investors, who wanted profits on their returns in the near term. Shah says he had an obligation to pursue the shorter-term model because of the belief that hurricanes had gotten more dangerous. How are you going to incent your underwriters if they don’t have the right kind of signal on what risk really is? He told the Herald-Tribune in 2008.

An accurate prediction of the new industry that has insurers calculating billions of dollars by indicating when to raise rates or drop policies in places most likely to be ravaged. It’s the difference between predicting how many times the number 1 will appear in 100 rolls of the dice, and anticipating what number is expected for the next five rolls. That, essentially, was what RMS promised. RiskLink 6.0, RMS chief research Robert Muir-Wood wrote in a February 2006 column, was the most eagerly awaited model ever introduced into the reinsurance market.

RUSHING TO RAISE RATES

Records show reinsurers and investors did not wait. Using numbers RMS provided in its promotional materials, they began increasing their own hurricane risk estimates 30 to 40 percent, six months before the new models came off the shelf. Florida insurers in turn sought rate boosts in anticipation of what the new model would do to their own costs.

A yet-unpublished five-year model did not become an industry standard until December 2005, when it was embraced by A.M. Best, the Chicago firm that provides financial ratings for insurance investors. Best said it would determine an insurer’s soundness by simulating its performance in back-to-back 100-year hurricanes as calculated by the five-year model.

The reasoning was simple. Catastrophe Models is under large threat of insolvency to an insurance company. Devin Inkslee, senior financial analyst at A.M. Best, said in an interview. According to a confidential presentation one of its officers gave at a conference, the company calculated its new hurricane model raised the expected cost of a ma-
A price based on a dubious model

MODELS from 141 for U.S. hurricane by $55 billion. Plugging that model into A.M. Best’s stress test meant the industry as a whole would need to raise $80 billion to remain solvent. RMS’ two chief competitors argued there was inadequate scientific grounding to justify a five-year outlook. Clark, at the time CEO of AIR Worldwide, said he urged A.M. Best to reconsider requiring a model “based on theory.”

Having alternative models available was good, she said, but “I personally was an advocate of not rushing into something that was not tested and would have a dramatic change. Certainly, I had a lot of conversations with A.M. Best.”

The warnings were not heeded. Both Eqxcat and AIR eventually produced their own five-year versions, though AIR warned clients it considered the only credible version to be the long-term model. By January 2006, five months before RMS released its new model, at least half a dozen reinsurers were pricing their contracts based on the new numbers, comments made in quarterly earnings calls show. The pricing triggered a cascade of rate hikes before insurers may use them to set rates. No short-term model has ever passed that test.

RMS in 2007 submitted its model for review by the Florida Hurricane Loss Methodology Commission — the only body of its kind in the nation. Meteorologists, statisticians and engineers for the commission began a lengthy review. But when RMS learned those reviewers planned to reject the model, the company withdrew it from consideration.

A draft report shows the objections centered largely on how RMS had determined its new hurricane rates. The panel said the model change failed to meet credibility and bias tests, and it questioned how RMS had picked its four scientists and why so few years were used.

Shah later told the Herald-Tribune the RMS models contained virtually every U.S. disaster in the last 200 years. His company’s predictions have helped reshape the industry. Los Angeles Times/Hans Luu/BEACH

MONKEYS COULD DO THIS

At the outset in 2005, RMS promised to revisit its forecast at the end of every season. “If there is a material change,” the company said, “rates would be updated.”

So it was in October 2008 that RMS assembled a group of seven weather science experts at the Hotel Victor on Miami’s South Beach. Rather than produce their own storm predictions, they were asked by an expert in gathering scientific opinion to rank 39 different climate models that RMS would then use to produce a five-year forecast. The man running the show was Tony O’Hagan, a British statistician who had developed drug trials for AstraZeneca. He came armed with Tallywinks, 30 for each scientist, to help them visualize and rank the weather simulators.

What struck University of Colorado environmental science professor Roger Pielke as he played with his pile of green chips was the pointlessness. Pielke, already a critic of the five-year forecast, believed the 39 models were a stacked deck, “biased upwards.”

RMS said it gave its experts the option of sticking with a long-term average. “We were strongly encouraged not to do so,” Pielke said.

Another participant, Georgia Tech climatologist Judith Curry, had her own misgivings. She believed the selection too narrow. “I thought all of the models were wrong. I didn’t have confidence in any of them,” Curry said.

When RMS averaged the scientists’ choices, the number of expected storms had dropped from the previous forecast by 30 percent. This time, the number of Category 3 and higher hurricanes expected to strike the U.S. each year dropped, from 9.9 to 8, a seemingly small change.

That decrease meant the risk of hurricanes had dropped by a third. Presumably, homeowners’ premiums should follow suit.

But there was no rush to adjust homeowners’ bills and no publicity surrounding the new scientific consensus.

RMS in December 2008 described the results as “consistent” with past findings. It disclosed the lower numbers six months later in an April 2009 confidential report to clients. By then it was too late to affect that year’s reinsurance rates for many insurance companies.

Company vice president Claire Souch said RMS promoted the increase and downplayed the decrease. “Our time lines were the same,” she said.

Even after it was released, brokers said, the average model was not roundly embraced. “It is true that many ‘set aside’ the previous finding in the short run,” she said.

Even if it was released, brokers said, the average model was not roundly embraced. “It is true that many ‘set aside’ the previous finding in the short run,” she said.

Following the unusually inactive 2009 season, RMS announced it would skip its annual exercise the following year.

By fall 2010, RMS had changed its methodology to remove the human element, Souch said. Souch said a new model will be released in February. It is expected to decrease rates along the coast and increase them inland, RMS officials said.

For his part, Pielke returned to Colorado and set up a random number generator to rank RMS’ 39 climate models from 2008 — akin to blindly throwing darts to choose the best model.

“The outcome poorly matched the scientists’ consensus. “So with apologies to my colleagues,” he wrote in his science policy blog, “we seem to be of no greater intellectual value to RMS than a bunch of monkeys.”
The cost of a spill that never got here

PROXIMITY CLAIMS: Florida businesses that suffered may overwhelm BP fund

HOW... Re

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www.heraldtribune.com  Sunday, October 24, 2010 11A

HERALD-TRIBUNE

Booker High School is working

ONLINE VOTER GUIDE

FAMILIAR, STADIUM SPARKED A RUN

By BARBARA PETERS SMITH

succeeding before 2013, be-

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INSIDE

TEAM EFFORT

What happens when

online?

STAFF PHOTO / PAIGE ST. JOHN

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FLORIDA

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of Florida reinsurance contracts.

the newspaper's analysis of 70

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After 2005, State Farm Florida doubled

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Amid champagne parties and sail-

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Herald-Tribune Investigation

The New Insurance Game

Sending Billions Overseas

By Paige St. John,
paige.stjohn@heraldtribune.com

Monte Carlo, Monaco — Never before have Floridians paid so much to protect themselves from hurricanes.

And never have they received so little benefit.

A Herald-Tribune investigation shows that since the state’s last spate of hurricanes, a dramatic shift has taken place. Two-thirds of property insurance premiums now leave Florida as unregulated payments to largely offshore reinsurers — companies that sell hurricane protection to insurers and that operate without rate control or consumer oversight.

They, more than state insurers and state regulators, determine how much Floridians must pay to live in the state, and whether property insurance is available at all.

Florida’s growing reliance on this profit-driven market is eroding its ability to withstand the inevitable disaster.

In the past four years, Florida-based home insurers paid out $15 billion for private reinsurance.

There has been no storm to trigger payments. Most of the money is gone, pocketed by a reinsurance industry that plays by Wall Street rules, able to rack up profits no regulated insurance company would be allowed to keep.

Without a major storm before next June, Florida’s lost capital will near $19 billion.

Had it remained in Florida, that money could have doubled the size of the state’s publicly run catastrophe fund and lowered premiums 20 percent. It could have paid for another round of hurricanes like the eight that struck in 2004 and 2005.

Instead, homeowners’ insurance premiums reached record levels in 2006 and 2007, exacer-

See INSURANCE on 10A
Insurance firms’ cycle of sending billions overseas

The Herald-Tribune

October 24, 2010

INSURANCE from 1A

bating widespread policy cancellations. The lost capital also weak- ened insurance company finances, drained surplus for future storms, and pushed carriers over the edge, giving Florida the high- est insurance failure rate in the na- tion.

The volatile reinsurance mar- ket now has such a tight hold on Florida that homeowners and the state economy are perpetually at risk of future market shocks, even those triggered by events else- where in the world.

The costly dependence frustrates those who would try to re- vive the state’s foudnering property insur- ance market. State Insurance Commissioner Kevin McCarty alternatively has called reinsurance the "crack addict" of Florida property insurance because it is così dependent on the high-priced market.

The paper learned that Bush secretly spent part of his last year in office seeking an alterna- tive, lobbying his brother in the White House and fellow gover- nors of catastrophe-prone states to create a government substitute. Four years later, a leader of state insurance agents reached a similar conclusion.

"We have no moral or legal obli- gation to provide this kind of cov- erage to people," Wilson de- clared.

Allstate and other national carriers accelerated a retreat from risk along the American coast. "It was a turning point for not just Flori- da, but from Massachusetts to the Gulf of Mexico," said state Insur- ance Commissioner McCarty.

But he far the money. "We need to be more nimble," McCarty said. "We can't afford to get caught in the same old insurance marketplace." McCarty then declared that the time had come for a government substitute.

"Yet we are a crack addict. We have to have it..." McCarty said.

"If the state had a crack addict, we would look for a solution," McCarty said, "and what we have is a government substitute." McCarty then declared that the time had come for a government substitute.

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The New York state norm for carri- ers is like ACA, a tiny New En- gland agency. "We are in the business. We are not the only ones," McCarty said. "If we are not the only ones, we have to get the crack addict out..." McCarty said.

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The insurers need considerable capital to supply this insurance and the cost of that capital is in- cluded in the premiums, they note.

After Hurricane Katrina, some of the highest rollers providing $33 billion to recapitalize the reinsur- ers of Bermuda included Leh- man Brothers and Goldman Sachs, and private investors re- cruited by Jeff Greenberg, son of former AIG chairman Hank Greenberg.

These new players demanded paybacks equal to or better than the heady profits rolling off mort- gage-backed securities. They sought return percentages from the mid-teens to high 20s, Mike Naughton, a managing director of Goldman Sachs, told reinsurance executives during a 2006 industry forum in Bermuda.

In the end, Bermuda reinsurance investors saw a record return on equity, according to a Guy Carpenter analysis. Greenberg had a 26 percent return on Vali- dus Holdings. Lancashire Re gave its New York private equity fund investors a 33 percent return. And in 2009, the largest reinsurer of Florida carriers reported a 38 per- cent return.

Being in Bermuda, the profits were tax-free.

On the other hand, Florida regu- lators limit property insurers to a 3.7 percent annual profit on their underwriting activities.

"Putting aside the tremendous human cost of natural catastro- phes, as an investment category, cat risk is actually quite wonder- ful," Greg Richardson, vice presi- dent of Harbor Point Re, told his peers at a summit in 2008.

As Insurers Spend more on Reinsurance, they have less mon- ey to set aside for future storms.

Called policyholder surplus, this stash represents the first line of defense for hurricane claims. To the alarm of industry watch- ers, it is weakening.

The surplus held by Florida- based insurers in 2003 was $2 bil- lion. It is now about $2.4 billion — an increase that has not kept pace with the amount of property these companies insure.

In 2003, Florida insurers had 65 cents in the bank to back every dol- lar of brick and shingle they in- sured. Now it is 42 cents.

The decrease is all the more alarming because it occurs during a full in hurricane activity, when Florida insurers should be build- ing capital to withstand future storms.

And it comes despite record rev- enues. Insurance premiums state- wide have climbed from an aver- age $885 per home in 2001 to $1,438 in June.

But in three of the past four storm-free years, the total amount of surplus held by Florida-based insurers gained only minor ground. In 2009, when reinsurers raised their Florida rates to counter Wall Street losses, it actu- ally dropped.

For some insurers, the surplus drain became a death sentence.

Since 2009, 10 carriers have fall- en so short on capital they have been forced to close, been placed under regulatory consent orders or had their financial ratings withdrawn.

Florida last year led the nation in property insurance company failures.

The view offshore is much brighter.

The U.S. hurricanes in 2005, par- ticularly Katrina, left the Bermuda reinsurers that provide most of Florida's hurricane coverage with net losses of $2.1 billion.


Executive pay for the top five of- ficers at Renaissance Re — Flori- da's biggest reinsurer — quadru- pled from $6 million in 2005 to $28 million in 2009. CEO Neil Cur- rrie's latest $7.6 million compensa- tion package included nearly half a million dollars to allow him and family members to fly between Bermuda and his home in North Carolina.

"They load the boat on the prof- its they make in Florida," said Jeff Grady, the president of the state agents' association.

Nowhere are the riches from Florida more on display than when the industry gathers on the French Riviera for its annual con- vention in Monte Carlo.

For a week during the height of the Florida hurricane season, the extravagant gambling resort is packed with hundreds of reinsur- ers and brokers who negotiate their contracts.

There is a single scheduled event — a poorly attended speech on some aspect of the market. Traditionally the sailboat race at the Monte Carlo Yacht Club. Some years there is also a road rally through the south of France in collectible cars.

Only the few contracts get signed in this open air market.

"The bulk of the week is devoted to "building relationships," a func- tion some reinsurance brokers say they hold more important than the price for any one year.

In 2008, as Florida gambled with the weather, hundreds of reinsurance underwriters and brokers packed the marbled lobby of the Hotel de Paris and commandeered the outdoor tables of the Cafe de Paris, befuddling cruise ship tour- ists who had nowhere to go.

Brokers huddled over spread- sheets beneath bronze busts of Louis XIV or, more typically, against a grand piano or beneath a Greek nude. The bigger reinsurance con- ferences are held forth from pri- vate salons and yachts tied up in the harbor.

"Uncivilized, isn't it?" a Bermu- da broker remarked unbidden, tak- ing refuge in a slice of shade at the cafe as he awaited a turn at the strangely public assassinations, the subject of which was death and de- struction.

At sundown the din yielded to a frenzy of sumptuous dinners and endless champagne.

The brokers from Guy Carpen- ter held a huge party in a balcony beneath a ceiling papiered in gold, lasers casting corporate logos atop the charting maps painted on the walls. "Do you realize $1 trillion of wealth is in this room right now?" remarked the impressed publicist for a catastrophe modeling firm. The brokers behind tables of green revenues and stilted magicians on stilts greeted dele- gates who entered through a veil of tiny bubbles, tossing firecrack- ers over their heads.

The impeccably dressed hosts from Dubai handed out party fa- vers of overzipped billboards, while a bus crouched at the curb to ferry brokers to the next soirée.

The terrace was a smorgasbord of se- quined starlets slid among the strolling financiers, trailed by backup dancers.

"They tried to make me go to re- hearsals," a top-hour cayman to the drinking brokers.

"I said, no, no, no . . . "

Florida's extensive spending on reinsurance helps fund the industry's annual gathering at Monte Carlo.

www.heraldtribune.com  Sunday, October 24, 2010

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HERALD-TRIBUNE INVESTIGATION

HOW STATE FARM CASHED IN ON A CRISIS

A Hurricane Katrina victim leaves no doubt that he would like a visit by the State Farm insurance adjuster in Gulfport, Miss., in 2005.

By PAIGE ST. JOHN, page.stjohn@heraldtribune.com

W hen State Farm stepped up its march out of Florida, it loudly and publicly claimed hurricanes were pushing it toward financial disaster.

The company argued it had to leave the Florida coast — and drop nearly half a million customers — because it could not profit in a state wracked by so many storms.

But State Farm never really left Florida.

A Herald-Tribune investigation finds Florida's largest insurer has instead found an easier way to profit from homeowners desperate for coverage. And the desperation State Farm helped create allows it to command some of the highest rates in the world.

The conduit for this back-door insurance is DaVinci Reinsurance Ltd., an offshore company with no physical office or employees of its own that sells policies to insurers to

See STATE FARM on 16A

FLORIDA'S INSURANCE NIGHTMARE

This is the latest in an ongoing Herald-Tribune investigation of Florida's property insurance system. For previous stories, go to heraldtribune.com/floridainsurance.

INSIDE

Graphic: Is your insurer backed by State Farm? 16A

Graphic: Shrinking at home, expanding in Bermuda. 17A

ONLINE: Is your insurer safe? Find detailed financial measures for more than 160 Florida insurers at heraldtribune.com/floridainsurance.
Dropping policies, State Farm still makes millions

STATE FARM from 3A cover their storm losses.

The virtual corporation was launched in 2001 by State Farm and a Bermuda reinsurer with which it has close ties.

State Farm provided $200 million in seed capital. Its partner, RenaissanceRe Holdings Ltd., took on management and the recruitment of other investors.

While it has little physical presence, DaVinci is now one of the state’s most important hurricane reinsurers. Contracts show DaVinci provided coverage last year to more than 50 Florida insurance carriers representing the owners of 3.7 million homes.

Through DaVinci, State Farm quietly continues to collect money from thousands of former customers who were told their homes were too risky to insure.

Collectively, these customers have paid hundreds of millions of dollars to State Farm’s offshore reinsurance venture. Without a hurricane, the $300 million in Florida premium paid to DaVinci from 2006 through 2009 has been largely profit. Florida’s payments for 2010 are not yet available.

The advantages to State Farm are clear.

In Florida, the insurance rates State Farm can charge are regulated by the government. Profits are controlled and taxed. The potential loss from a major hurricane is measured in billions of dollars. DaVinci’s premiums, on the other hand, are as high as the market will bear. Based in Bermuda, it avoids U.S. taxes and faces no limit on profits. If a hurricane strikes, State Farm would lose no more than its investment in DaVinci — $500 million at the end of last year.

State Farm officials would not disclose the company’s current ownership interest in DaVinci. Nor would RenRe release the names of DaVinci’s directors.

Securities filings show that since 2008, State Farm has had an option to leave DaVinci, but as of December 2009 it had not exercised that right.

A spokesman for State Farm responded to questions from the Herald-Tribune with a two-sentence statement.

“Reinsurance exists to help insurers protect homeowners from major catastrophes,” wrote spokesman Phil Supple. “In this instance, State Farm is simply an investor and not actively involved in this reinsurer’s underwriting decisions.”

Stacked against State Farm Mutual’s $92 billion in assets, the investment in DaVinci is small. The cash payout so far has been only $300 million in dividends split between State Farm and other investors, including the Ontario Teachers Pension Fund.

But the impact on Floridians has been huge.

DaVinci helped facilitate the transformation of Florida’s home insurance market into one reliant on thinly capitalized, Florida-based companies and unregulated offshore reinsurance.

DaVinci, along with its partner RenaissanceRe, writes a specialized form of reinsurance that allows investors to launch and operate new Florida insurers with relatively little cash.

“It brings more capacity . . . I would welcome State Farm to do more of it in a heartbeat,” said Joe Graganello, president of two Florida-based insurance companies, Capitol Preferred and Southern Fidelity, which buy coverage from DaVinci and RenRe.

Without that protection, it would be hard to do business, Graganello said.

The expansion of DaVinci’s coverage in Florida, however, was also self-serving.

DaVinci’s presence made it easier for State Farm to withdraw from Florida’s densely populated coastlines and in five years shed more than 865,000 customers — by helping give those customers a place to go.

That, in turn, aided State Farm politically.

The company’s withdrawal has put pressure on lawmakers to give concessions to the insurance industry, but is not so cataclysmic as to prompt state intervention to prevent it.

In the end, Florida officials allowed State Farm to sharply raise rates and eliminate policy discounts while shifting to safer parts of the state and retaining its highly profitable auto insurance operation in Florida.

Earnings protections filed with state regulators show State Farm expects to collect as much premium in 2011 as it did before its exodus.

“State Farm has done a good job, an excellent job, in pulling the wool over the eyes of many of my colleagues in the House and Senate,” said state Sen. Mike Fasano, a Pasco County Republican and a critic of State Farm.

“They’ve convinced them that State Farm is poor and they’re losing money and the Legislature is willing to come to their rescue.”

OPPORTUNITY IN DISASTER

DaVinci emerged from the rubble of the World Trade Center.

Within weeks of the Sept. 11 terrorist attacks in 2001, it was created by State Farm and its Bermuda partner, RenaissanceRe, to capitalize on price increases that followed the disaster.

State Farm’s original $200 million stake gave it a 46 percent share in DaVinci and a seat on the board of directors. RenRe provided 20 percent of the money and manages the venture.

At the outset, DaVinci was a nominal reinsurer for Florida. It specialized in low-risk contracts with large U.S. insurers such as Allstate and Zurich American.

That changed after Hurricane Katrina in 2005.

To take advantage of rising reinsurance rates, DaVinci shifted its attention to hurricane risk, raising $275 million, including $225 million more from State Farm. It doubled its staff to write reinsurance and refocused much of its business on Florida.

Together, DaVinci and RenRe became the largest provider of hurricane coverage to Florida-based insurers.

The rates they charged Florida insurers post-Katrina doubled, RenRe executives told stock analysts at the time.

The company’s pursuit of such distressed markets is a central part of its business philosophy.

“Where there’s guarding we don’t run toward the bullets, but we like to get involved when there’s still smoke in the air,” RenRe CEO Neill Currie told the Herald-Tribune two years ago at a reinsurance gathering in Monte Carlo. “It works out pretty well, because we come riding in on the horse.”

National reinsurance records show that in 2005, Florida-only insurers provided 23 percent of DaVinci’s U.S. revenue. By 2009, it was 41 percent.

Interviews and documents examined by the Herald-Tribune show DaVinci focused on selling the claim that its reinsurance coverage was most critical to Florida’s weak property insurers.

There is little competition in that niche, and reinsurance brokers said the price for such protection is among the highest in the world, sometimes more than 50 cents for $1 in coverage.

“Opportunistic” is the absolute key word,” said John DeMartini, vice president at Towers Watson, See STATE FARM on 17A.
Insurer swapped risks for profits

STATE FARM from 16
a national reinsurance brokerage. “DaVinci cleverly stepped into the void.”

What’s more, State Farm organized its withdrawal in a way that helped it keep control of its most profitable business — car insurance.

It created a list of insurers to which State Farm agents could direct dropped customers. Homeowners who switched to those companies could retain their multi-policy discounts.

State Farm agents also keep their clients if they move them into the state-created Citizens, or to the pre-approved companies — most of which are backed by DaVinci reinsurance coverage.

Details about DaVinci were kept quiet enough that several longtime Florida State Farm agents told the Herald-Tribune they were not aware most of the pre-approved companies had a connection to State Farm.

EVERYWHER,E, A BIT OF STATE FARM
Tampa resident Trudy Hensley canceled her State Farm home and car policies in 2009 after seeing her premium jump 66 percent in two years.

State Farm’s threat to drop Florida residents angered her enough to look for coverage elsewhere. She switched to Tower Hill.

What she did not know was that the Tower Hill group, including four insurers under that umbrella, is by far DaVinci’s largest Florida customer.

The Tower Hill companies together paid State Farm’s reinsurance venture more than $48 million in premiums from 2004 through 2009.

“T’s very unethical, I have no feelings of Good Neighlbors,” Hensley said. “I’m not happy at all. It’s another case of those big insurance companies taking advantage of people.”

Hensley’s first reaction after being told about DaVinci was to ask for a list of companies that do not buy reinsurance from the company.

It would be hard to find one.

By 2009, DaVinci, in partnership with RenRe, had provided some hurricane protection for 54 Florida insurers, including Allstate and fast-growing Universal Property & Casualty.

The duo supplied the majority of hurricane protection for six companies, a list that included Security First, Argus and the now-defunct Northern Capital.

Aging financial contracts reviewed by the Herald-Tribune, DaVinci was the third-largest commercial provider of hurricane reinsurance in Florida by the end of 2009.

As State Farm dropped customers along the Florida coast, many remained in the State Farm family when they were picked up by companies using DaVinci reinsurance, including Northern Capital.

The Miami-based insurer was started in 2007 by the owners of a security guard company. Alexander Anthony and Albert Fernandez put up $8 million and approached state regulators with an offer to take on more than 45,000 homeowners who had been dropped into a state-run program by State Farm and others.

Like many Florida start-up insurers, Northern Capital lacked the money to insure that many homes.

It could have drastically scaled back its growth plans to fit the money it had. Instead, it devoted two-thirds of its income to buy reinsurance, letting it insure thousands more homes.

Northern Capital concentrated its business in Miami-Dade County and adjacent areas — a region State Farm closed to new business in 1992. Despite that, 90 percent of Northern Capital’s private reinsurance in 2007 came from DaVinci and RenRe.

The deal was a fertile opportunity for State Farm’s venture. Northern Capital paid DaVinci as much as 40 cents for every $1 in protection it received, akin to paying $800,000 a year to insure a $200,000 home.

A risk assessment done for state regulators shows Northern Capital’s coverage from DaVinci had a technical value — the average annual expected hurricane loss — of no more than 4 cents per $1 insured.

But DaVinci demanded to be paid 10 times the actual risk. That cost landed on homeowners.

A Herald-Tribune review of scores of reinsurance contracts found similar terms for other companies.

In 2009, Southern Fidelity paid 52 cents for every $1 of protection bought from DaVinci and RenRe. Homeowners Choice paid the two companies 43 cents per $1 of protection.

Capitol Preferred also bought high-risk coverage last year at 57 cents on the dollar; Gulfstream paid 52 cents for every $1 of coverage.

At Northern Capital, the contracts worked out better for State Farm than for companies that bought the coverage. With no hurricanes, DaVinci kept the $20 million it collected from Northern Capital.

In early 2009, state regulators accused Northern Capital of paying too much for reinsurance and put it under secret supervision.

A year later, the company had so little money regulators shut it down.
FLORIDA CABINET: Leaders call for closer look at payments to affiliates

By LLOYD DUNKELBERGER
and PABRAZ
H-T Capital Bureau

TALLAHASSEE — Gov. Charlie Crist and state Cabinet members called Tuesday for increased scrutiny to determine if Florida property insurers are paying their affiliates as much as they should.

Following a years-long investigation, the Herald-Tribune reported that about half of the $3.8 billion in premiums that Florida insurers moved to their own subsidiaries was for management services provided by their own workers.

Consumer advocates warn that those bills are easily inflated, and that as a result, Floridians pay 50 percent more than the national average for insurance over-head costs.

The Herald-Tribune also revealed that Florida law specifically prevents regulators from tracking those payments.

Crist said he was willing to push legislation to close the loophole “on behalf of the consumers.”

“I think it would be a great piece of legislation that I would like to sign,” the governor said.

McCollum raised particular concerns over whether insurers that received $250 million in state loans were funneled money to themselves through such business arrangements.

Of the 13 that took the low-interest loans, two have been ordered to return some of the diverted premiums. Deputy Insurance Commissioner Belinda Miller on Tuesday said a third, Amerisite, a company she has agreed to return some of the fees. Financial records reviewed by the Herald-Tribune show nine other state-financed insurers paid themselves a collective $62 million in 2008 and 2009, awarding themselves commissions as high as 20 percent and receiving automatic profit increases when rates increased.

The debate over management companies came as McCarty updated Crist and Cabinet members on the state’s frail property insurance market with hurricane season a little more than two months away.

McCarty on Tuesday said more insurers will fail, but he did not cast that as a concern. “Even when we have a strong economy, we have insurance failures,” he told Cabinet members.

The Herald-Tribune investigation revealed that more than 2 million Florida families are covered by insurance companies that exhibit signs of financial weakness.

The report also noted that six Florida home insurers in 2009 were declared insolvent or were forced to close or sell, despite the fact the state has not had a hurricane in four years.

McCarty credited his office for “mitigating” the impact of those failures on a consumer-supported solvency fund, but took criticism for keeping consumers in the dark.

“We need to be confident to prevent the proverbial run on the bank,” McCarty said.

Financial records and industry sources indicate more companies are under scrutiny or are in trouble. Some carry less capital than regulators say is safe. Others have too much hurricane risk, or are heavily leveraged.

Year-end financial reports filed by the companies earlier this month showed heavy losses continue despite the absence of hurricanes, adding pressure for regulators to allow carriers to raise rates.

“Clearly we can’t have these same losses year after year,” said Chief Financial Officer Alex Sink, who had asked McCarty for the public briefing.

After the meeting, Sink said she was satisfied with McCarty’s report.

“What I heard was that we’ve got a number of Florida domestic insurance companies who are not in the greatest financial condition and I feel that we got the commissioner’s attention,” Sink said.

She also said she supported the move to require more disclosure of the companies’ dealings with their affiliates.

“Clearly there are a lot of loopholes. And some of the companies have taken full advantage of these loopholes to put the money in a place where it cannot be recaptured,” Sink said.

Two-thirds of the 66 insurers that operate primarily in Florida reported losing money on the insurance side of their business in 2009. Three companies ended the year without sufficient money to meet the state’s minimum solvency requirements and a fourth, Magnolia Insurance, was placed under state supervision and did not report its financial position.

The continued losses are eating away at Florida’s hurricane defense. One out of three Florida-only property insurers reported decreases in the surplus to protect homeowners against hurricanes. Leading the list were:

- State Farm Florida: $241 million
- First Home Insurance: $26 million
- Universal Insurance of North America: $16 million
- Northern Capital Insurance: $14 million
- Olympia Insurance: $2 million

SOURCE: 2009 annual reports of 66 Florida-only property insurers.

INSURERS’ DEALS PROMPT SCRUTINY

INSURERS from J.A. that would allow regulators to monitor payments to affiliates, noting that once premiums are moved out of the insurer, there is “no way to get the money back.”

“Transparency in this process would help us improve our great deal,” McCarty said.

Following a years-long investigation, the Herald-Tribune reported that about half of the $3.8 billion in premiums that Florida insurers moved to their own subsidiaries was for management services provided by their own workers. Consumer advocates warn that those bills are easily inflated, and that as a result, Floridians pay 50 percent more than the national average for insurance overhead costs.

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SOURCE: 2009 annual reports of 66 Florida-only property insurers.
State faults founder’s stock deal with insurer

REGULATORS: Company is told to try to recoup the $600,000 it lost

By PAIGE ST. JOHN
paige.stjohn@heraldtribune.com

State regulators have ordered a Florida property insurer to recoup $600,000 paid to the company’s founder for what turned out to be worthless bank stock.

The February 2009 transaction, outlined in a Herald-Tribune story two weeks ago, allowed Hillcrest Insurance founder Vernon Smith to sell stock in one of several troubled community banking ventures Smith had formed.

Seven months later, that stock proved worthless, contributing to a loss for the Hillcrest insurance operation.

In an order released Thursds.

INSURE: from 1A

day, the Office of Insurance Regulation ruled the stock purchase was not in the best interest of the insurer company nor its policyholders, and “was a violation of the fiduciary relationship to Hillcrest resulting in personal financial gain.”

Smith refused that characterization.

“The moment I sold that stock, it was worth what I sold it for,” he said. “I thought it was a good investment.”

The stock was in the Riversides Banking Co., which was under scrutiny at the time by federal banking officials. Smith said he sold the stock, once priced at $800 per share, for $50 per share, expecting that it would rise in value. Instead, it dropped.

In this week’s order, regulators call for Hillcrest to try to recover the lost money. Further, it states Smith has six months to divest all interest in the family-controlled insurance company, whose president and insurer is his son-in-law and daughter. Smith said he “work to make sure it happens.”

Hillcrest also is required to pay a $10,000 penalty.

Starting last month, the Herald-Tribune began running a series of stories reviewing the results of a year-long investigation into the insurance industry.

Those stories mentioned the Hillcrest stock deals and millions of dollars in other insider payments made by insurance companies to their owners.

Tuesday, Insurance Commissioner Kevin McCarthy addressed some of the newspaper’s findings to Gov. Charlie Crist, who said he would support legislation that would allow state officials to track payments made by insurers to subsidiary companies.

That legislation, sought this week by the Office of Insurance Regulation, hit an early roadblock Thursds.

House insurance chairman Pat Patterson, R-DeLand, sought to introduce a provision that would require insurance companies to report their entire profits — including the money they divert to affiliates and other related parties.

The measure also would have limited the ability of those affiliates to pass profits on to investors while their insurance companies operate post losses.

Patterson’s provision includes a finding that such transactions have “the potential to jeopardize the financial viability of the property insurance marketplace in Florida.”

Despite early endorsement by Commissioner McCarthy and Crist, the provision was voted down Thursday by the House Insurance, Business and Financial Affairs Policy Committee.

Patterson blamed heavy lobbying by property insurers, who attacked the disclosure requirements as “bad for business” and “over-regulation.”

A similar provision was offered in the Senate by Sen. Mike Fasano, R-New Port Richey, failed to be introduced Wednesday when the committee ran out of time.

Another champion of the legislation, Chief Financial Officer Alex Sink, said she was “disappointed that the House Insurance Committee chose not to take action to protect Florida’s consumers from these possibly abusive practices.” She urged lawmakers to reconsider, “to provide much needed oversight and transparency.”

Fasano and Patterson said they would continue to try to find a way to introduce their bills.

The legislative attempts come two weeks after stories by the Herald-Tribune documented the shift of $1.8 billion in premiums out of Florida property insurers to related businesses, often housed at the same location and employing the same people.

The newspaper showed how those payments made profitable companies appear to generate large losses, resulting in rate hikes and insolvencies.

State regulators fault stock deal between an insurer and its founder

CHOICE: from 1A

State rebukes firm

FICE did not release a copy to the Herald-Tribune until Friday.

Company vice president Jay Mahdavi did not respond to a request for comment.

The Clearwater-based company is the third insurer to be threatened with suspension of its license in two weeks.

Hillcrest Insurance earlier this week was ordered to recoup $600,000 it paid a company director for stock that became worthless.

Southern Oak earlier this month was accused of using internal management contracts to collect $30 million in excess profit from its insurance operation.

The Office of Insurance Regulation refused to comment Friday on whether it was examining other such transactions reported by the newspaper.

State rebukes firm
Insurance official is rolling the dice with state policies

FLORIDA ROLLING DICE ON INSURERS

State official defends his decision to try risky strategies

HOMES: State official defends his decision to try risky strategies

By PAIGE ST. JOHN

Under questioning by his boss, Florida’s top insurance regulator revealed his office is using new and risky strategies to keep property insurance rates low and troubled companies in business.

Insurance Commissioner Kevin McCarty, for the first time, publicly described these strategies, which include allowing a nearly bankrupt insurer to continue writing policies without warning homeowners.

He defended other tactics, including letting companies drop unwanted customers and ending requirements that once ensured companies would have the resources to cover even the worst hurricanes. In early April, the Office of Insurance Regulation told Florida property insurers they no longer needed the resources to pay for a 1-in-100-year storm, a long-standing standard.

The goal, McCarty said, is to reduce insurance costs and keep private insurers in business in Florida’s increasingly fragile market.

McCarty’s written explanation of the new policies came in response to questioning last week by Chief Financial Officer Alex Sink, who challenged what she called “a fundamental shift” in regulation.

Sink issued the questions after a Herald-Tribune investigative series revealed dozens of Florida property insurers exhibit signs of financial weakness. The series exposed several cases in which regulators allowed failing companies to continue writing policies without warning homeowners.

McCarty’s response was delivered to Sink on Thursday night, just after his office sought a state order to shut down Magnolia Insurance, the state’s fifth failed insurer over the past year.

In the response, McCarty said his agency gave one failing company permission to continue writing policies — something his office previously denied in statements made to Sink’s office. The commissioner did not answer Sink’s demand for a list of every uninsured policyholder permitted to sell policies to unsuspecting homeowners.

By December 2009, McCarty knew Northern Capital Insurance could not afford to pay claims for a major storm. But instead of shutting down the Miami-based carrier, he gave it time to find a buyer and allowed it to write new policies until at least February, McCarty said. Northern Capital was allowed to renew existing policies until the day it was shut down.

McCarty defended that action, telling Sink it was important to preserve Northern Capital’s value for a potential buyer.

Canceling policies, he said, “would cause uncontrolled deterioration of the book of business, rendering any sale of the company impractical.”

That explanation angers Sarasota resident Sharon Brown, who sent Northern Capital a $364 renewal check just weeks before regulators admitted the company was insolvent.

“How can the state give a company a license to steal?” she asked.

McCarty’s response to Sink suggests Northern Capital was the only company that received state permission to continue writing when it was near failure. But at least two others renewed policies after they had been deemed impaired, the Herald-Tribune found.

Both companies, American Keystone and Edison, eventually failed or were sold.

It is a felony in Florida for an impaired insurer to sell coverage, unless it has the express permission of the state insurance commissioner to do so.

Sink also called on McCarty to defend a new rule lifting a long-standing requirement that property insurers either have the cash or purchase reinsurance to be able to pay claims from a 1-in-100-year storm.

McCarthy said that he was forced by reinsurers’ predatory pricing to drop the requirement and that regulators would decide how much protection is enough on a case-by-case basis.

“The office is attempting to create rate relief,” McCarty wrote.

Buying less protection saves companies money, but leaves homeowners more vulnerable.

“This one stuns me,” said Jeff Grady, president of the Florida Association of Insurance Agents, who said the rule change benefits only insurance companies in danger of collapse.

“They can buy less and roll the dice, but their ability to pay the claim is jeopardy,” Grady said. “If they can’t pay the claim, what are they selling?”

It is not clear how many insurers companies actually will reduce their reinsurance coverage. The 100-year threshold is a common industry standard and McCarthy said most insurers will choose to meet it despite the relaxed rule.

Insurers that drop such coverage face downturns in financial scores they receive from private rating agencies such as A.M. Best and Demotech.

But McCarthy argued that if insurers have the latitude to reduce their reinsurance, they are in a better position to negotiate lower prices.

The president of Demotech, the rating firm that grades most of Florida’s small carriers, met with McCarthy to discuss the conflicting requirements.

“We agreed we don’t need to agree,” Demotech Joe Patrelli stated, declining to discuss details of how his firm will proceed.

Sink’s staff on Friday said she has asked Gov. Charlie Crist and Attorney General Bill McCollum to take up McCarthy’s responses at a public meeting May 11.

The three executives preside over McCarthy and his Office of Insurance Regulation.

The state’s continued problems with insolvent insurers is having other ripple effects.

In earnings calls with financial analysts, insurers have begun openly talking about the “credit risk” of doing business with Florida insurers that may not be able to pay their bills.

Meanwhile, agents asked to find new homes for two companies currently being liquidated, Northern Capital and Magnolia, have complained to the state they now lack the ability to determine which insurers are safe for their customers.
How risky is your insurer?

The Herald-Tribune used financial reports filed with the stats to rate each insurer on key indicators of financial health. Experts say these measures cannot determine if a company will fail, but scores in the red zone raise concern. Because of how financial data is reported, only companies that primarily insure homes within Florida are included.

Reserves
Florida regulators believe insurers need at least $10 million set aside for emergencies. Less than that pushes companies into the red zone.

Risk-to-capital
This measurement weighs cash reserves against a company’s risk. The more risk — from market investments or from policies written — the more cash is needed to offset it. The higher the score, the better.

Leverage
Some experts frown on companies that have less than $100 set aside for every $100,000 in property they insure. The more they have, the less likely they are to have cash-flow problems.

South Florida risk
Too many policies in one place is dangerous, especially if they are in hurricane-prone South Florida.

The Florida market
These charts show how many policymakers statewide are covered by companies that fall in the red zone, using the same measures as those rating individual companies.

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**Supplemental Material:** February 28, 2010

**ANALYSIS / PAGE ST. JOHN**

**STAFF GRAPHIC / JENNIFER F. A. BORRESEN**

**SOURCES:** Herald-Tribune analysis of financial and exposure data for Florida domestic property insurers in 2008 from the National Association of Insurance Commissioners and Florida Office of Insurance Regulation.
HERALD-TRIBUNE INVESTIGATION

THE NEW INSURANCE GAME

HOW BERMUDA RIGS RATES

Renaissance Reinsurance, the largest private source of Florida hurricane coverage, dominates the waterfront in Hamilton, Bermuda. The company reported a 38 percent return in 2009 even as Florida insurers struggled to stay afloat.

PHOTO PROVIDED BY BANK TATAM

By PAIGE ST. JOHN, paige.stjohn@heraldtribune.com

HAMILTON, Bermuda — In early 2006, Florida was on the verge of a financial disaster.

After two deadly hurricane seasons, major insurance carriers were leaving, smaller companies struggled to raise capital and Florida families scrambled to find coverage and pay escalating premiums.

As they strove to recover from the eight hurricanes of 2004 and 2005, Floridians took another hit — from Bermuda reinsurance companies that seized on the crisis to double or triple their rates.

These reinsurance companies, which insure the insurance companies, are the lifeblood for scores of under-capitalized, highly leveraged start-up insurers. Most carriers could not remain in business without costly reinsurance policies geared to cover their losses.

But in 2006, many reinsurers reduced the storm coverage they were willing to give Florida. Some purposefully refused to write policies for months, convinced they could extract an even higher price from insurers that neared collapse.

First-hand accounts, brokerage reports and copies of reinsurance contracts written that year show Florida insurers were still cobbling together hurricane protection in August and September, during the peak of danger, and paying three times the January rate.

The cost was paid by Florida property owners, some of whom suddenly faced premiums as high as their house payments. Real estate agents complained they were losing home sales as buyers no longer

INSURANCE NIGHTMARE
This is the latest in a yearlong Herald-Tribune investigation of Florida’s precarious property insurance system.

NOT SPOTLESS
Two of Florida’s largest Bermuda-based reinsurance providers have entered settlement agreements after coming under scrutiny.

HOW SAFE IS YOUR INSURER?
Go to heraldtribune.com/insuranceapp on the Web or point your mobile device to heraldtribune.com/insuranceapp to compare insurance companies.

COMING SOON
The newspaper’s coverage of insurance will continue in the coming months. Next: A surprising lack of science is behind the computer models that drive your rates.
Florida beholden to tiny island for home insurance

BERMUDA from IA

qualified for mortgages, and Flori-da bank leaders trouped to Tallahassee begging relief. The squeeze was legal, and opportunitistic.

"That's what we saw after hurri-cane Andrew and that's what will happen again, in my opinion, the next time we have a major hurri-cane," said Steve Alexander, actua-ry for the office of the Florida Insur ance Consumer Advocate.

REINSURANCE OPERATES ON a global scale, regulated to some extent in Europe and hardly at all elsewhere, especially in Bermuda, a tax haven.

The tiny volcanic rock 600 miles east of North Carolina is home to nearly half the reinsur-ance sold to Florida, a $470 billion powerhouse crammed in a few blocks between the rum bars and T-shirt shops.

There are more than 1,200 for-eign insurers incorporated in this oceanic frontier town, including 59 reinsurers that provide billions of dollars of hurricane protection for nearly every home in Florida, from swamp trailer to coastal high-rise.

They crowd and color every as-pect of Bermuda. With no place to build, newcomers worth hun-dreds of millions settle for whatever they can lease. Two crum offices next to a hair salon, heralded by wooden signs of equal size.

With no place to park, wealthy execs buzz around on motor scooters, ties flapping and knees peeking beneath colorful Bermu-da shorts, one of the persisting oddities cultivated by the island's financial expats.

An industry broker once dubbed them the "almost-pirates of the almost-Caribbean." Bermuda's regulations are fa-mously light, exposing consumers to business practices designed to reduce competition and encour-age price-fixing.

Solvency requirements exist, but they are dramatically light compared with what private finan-cial rating firms consider reason-able. Only the island's 37 largest re-insurers must file audited annual reports. Only 29 of those agree to make the document public.

The only other records Bermu-da allows the public to view are kept in a drab office building two blocks from the harbor. Hidden on the third floor, behind a wob-bl ing counter propped against the wall, a government clerk will fetch all that Bermuda cares to make public about the financial gi-ants who shoulder Florida's tre-mendous hurricane risk.

The manila files are virtually empty.

What they do contain is unhelp-ful — mostly lists of island law-yers who serve on boards of con-vience that hide the real own-ers and decisionmakers.

The STREETS OF New Orleans were still flooded in 2005 when re-insurers started raising money to pay for Hurricane Katrina and take advantage of the market boom expected to follow.

By December, Bermuda's rein-surers had raised $37 billion from eager investors, primarily hedge funds, private equity firms and U.S. investment banks such as Merrill Lynch, Goldman Sachs and Lehman Brothers.

But the flood of new money was not used to make more hurri-cane coverage available to Flori-da.

Reinsurance contracts and com-mits by executives show that even when they had money in the bank and board approval to use it, Bermuda reinsurers cut the capi-tal they were willing to allot to Florida.

The layoff in part was driven by the belief global warming had in-creased hurricane risk, a view backed by some scientists hired by the insurance industry.

But it also was driven by a hun-ger to maximize profit — to, as AIG Ltd. Chief Executive Officer Evan Greenberg told investors in a 2006 earnings call, "ruthlessly take the elevator up at the right times."

Rather than just ride Katrina-driven price increases, the Herald-Tribune found, reinsurers worked to make them bigger. They sat on business they normal-ly would have written. They turned away Florida insurers they normally would have backed.

"It’s a good tactic to do this," As-rencio Reinsurance CEO Chris O’Kane told stock analysts in ear-ly 2006. When he spoke, Aspen had written only half its normal Florida contracts.

"We’re confident that we will be able to replace a significant part of this lost exposure by the middle of this year at much better prices," O’Kane expected reinsurance prices to double because Aspecn was not the only reinsurer refus-ing to write. Other reinsurers also were holding out.

Risk Capital chairman John Charman started the Florida writ-ing season predicting severe short-ages, and ended it by confirming in an earnings call, "We held back capacity."

Other reinsurers were willing to write policies but seized on the opportunity to boost profits in oth-er ways.

Montpelier Reinsurance, for ex-ample, stopped selling a broad form of coverage on which many Florida reinsurers relied and of-fered a more expensive substi-tute.

"This is an unprecedented mar-ket disruption," Taylor said in the conference call, "providing oppor-tunities for those who have available capacity."

By July, Florida’s cost to rein-sure against the biggest hurri-canes ever to strike the state had tripled.

Aspen’s O’Kane told analysts he was still withholding capacity, confident Florida insurers would return in a few months as "dis-tributed buyers."

Florida home insurers com-plained prices rose so fast they were "written in pencil." Security First president Locke Burt, seek-ing rate increases of his own, told regulators he would secure a quote only to discover “a month later our price was two times, then three times” the quoted amount.

Florida regulators began a watchlist of insurers without full coverage at the start of hurricane season. Industry sources said five insurers were put under tempo-rary supervision. Claims ob-tained by the Herald-Tribune show at least one, United Proper-ty and Casualty, was still short in mid-September and operating un-der a regulatory consent order, even as it seemed a stout loan to face.

The average cost of reinsurance coverage in Florida climbed from $9.90 per $100 in exposure to $20, the highest in the nation.

The average home premium in-creased 80 percent. Residents near the coast saw increases of 300 percent. More than 300,000 Florida families lost their private coverage, forced to find a new company or join Citizens, the state-run insurer of last resort.

A few industry leaders were troubled. Bill Riker, president at the time of Renaissance Reinsur-ance, said the Bermuda reinsurers overcharged, hurting their own market. "The reinsurers didn’t do themselves well at all," he told the Herald-Tribune. They "lost track of what they’re all about."

Most reinsurers simply re-jected. Aspen Re ended the year with a $378 million profit, more than double what it lost to Katrina.

THANKS TO ANOTHER indus-try practice, every reinsurer en-joyed a piece of the profit, even if they had sat out the square game.

A Florida insurer typically needs to buy reinsurance from a dozen or more reinsurers who each agree to pay a portion of the losses.

But the prices on those con-tracts are set by consensus, not competition. And only a handful of the largest reinsurers partici-pate in the negotiation phase.

A reinsurer who has the largest See BERMUDA on 7A

Florida Armenie giantst crowd tiny Hamilton, Bermuda, where they can avoid taxes while staying close to their U.S. clients and investors. Staff Photos / PAUL ST. JOHN
BERMUDA from 6A

The widespread use of “best terms” clauses ensures that every competitor on a contract gets the highest rate paid. It robs consumers of the benefit of competition.

Industry leaders contend the process stabilizes prices and protects consumers from reinsurers that might bid too low and go broke when disaster strikes.

Some downplay the impact and argue the alternative could create more problems. “I don’t think it restricts competition at all,” said Ken LeStrange, CEO of Endurance Specialty Insurance Ltd., one of the largest Bermuda reinsurers of Florida property insurers. Open competition on price, he said, “would be quite chaotic. I don’t see it happening.”

Florida is particularly vulnerable to the lack of competition.

The state represents the largest catastrophe risk in the insured world. It also has more small, thinly capitalized insurance companies than any other state.

Thus, Florida demand for reinsurance almost always outstrips supply, most of which comes from a few dominant reinsurers.

“It’s an oligopoly, I don’t know what else to call it,” said St. Johns Insurance president Reese Bunn. Oligopolies can artificially drive prices higher without explicitly trying, a practice economists call “Tacit collusion.” Such actions are difficult to control and frustrate antitrust authorities, international law expert Sigrid Stroess told the Herald-Tribune.

What’s more, the insurance industry as a whole is largely exempted from antitrust laws.

“It’s not a free market when people conspire to set rates,” said U.S. Rep. Bill Posey, a Republican from South Florida who for years chaired the state Senate’s insurance committee.

American regulators have raised no challenge to consensus pricing. But controversy surrounding its use overseas prompted the European Union to investigate in 2007.

Examiners concluded such practices distort market prices, “to the benefit of the reinsurers imposing it and to the detriment of the reinsured.”

Brokerage reports show state residents suffer even when a big storm like Katrina is not distorting the market.

A plot of capital and soft markets drove U.S. reinsurance prices down 15 percent in 2009. But in Florida, according to insurance broker Guy Carpenter & Co., they fell only 5 percent.

MOST OF THE MONEY behind Bermuda reinsurers comes from the U.S., as does most of the business. But the profits Bermuda reinsurers make are, under Bermuda law, tax-free.

Regulation of Bermuda’s L240 insurers is left to the Bermuda Monetary Authority, which is not an arm of government. The independent organization is run with oversight from a board that includes executives of the very companies it oversees.

The system is structured to allow multimillion-dollar ventures to spring to life in weeks. New executives and their business plans are reviewed by a panel of executives from other firms, not by regulators.

By comparison, it takes months of regulatory review to launch a Florida insurance company. State officials require criminal background checks and must examine the capital sources behind a new company.

Solvency requirements, though changing, remain light. In 2008, Bermuda for the first time determined how much money a reinsurer needed by how much risk it assumed. But the level was set so low it provided little protection.

Renaissance Re, the largest carrier of Florida hurricane risk in the world, needs $365 million to meet Bermuda’s requirements. To keep an A grade from financial rating firm A.M. Best, it carries more than $1.5 billion.

In places, the lines between regulator and regulated are blurred.

Paula Cox is the Bermuda prime minister of finance, as was her father before her. She also is a lawyer for ACE Ltd., the island’s largest reinsurer. Her brother, Jeremy Cox, is the supervisor of insurance, responsible for setting the standards Bermuda reinsurers must meet.

Supporters argue such intimacy is why Bermuda succeeds.

“There are few secrets here,” trade representative Brad Kading noted in an essay on Bermuda reinsurance. “That serves a self-policing role in meeting the business ethics tests.”

Bermuda officials and their supporters insist the island is making strides in matching European countries.

“You could use ‘light touch’ as a pejorative, or you could use it as the way to go,” said David Ezekial, president of International Advisory Services, a Bermuda firm that specializes in launching new reinsurers.

They also point out billions of dollars from Bermuda helped rebuild after Katrina.

“We are good for America,” said Axis Re chairman Michael Butt. “In 20 years’ time, this is going to be Florida’s survival.”

— Julie Sullivan

www.heraldtribune.com  Monday, October 25, 2010
Security found law in courts

The Associated Press

ENGLEWOOD, Colo. — Security training at some federal courthouses may not be as tight as it should be, according to a new audit that found gaps and recommended several improvements.

"The Trail of Tears," a 20-minute film about the brutal words and actions of the U.S. Army against the Cherokee Nation in the 1830s, was not halted when a man with a gun interrupted it at the beginning of a recent trial.

Two days after that incident, the U.S. Department of Justice’s Office of Inspector General announced that it would conduct a nationwide review of courthouse security, following a recommendation from the National Institute of Justice.

The auditor general’s report, released Friday, found that many courthouses did not have proper security measures in place to prevent such incidents from happening again.

For example, at the District of Columbia Superior Court, where the film was shown, there were no security personnel present to stop the man.

The report also found that many courthouses did not have proper procedures in place to handle situations like this in the future.

"Courthouse security is critical to maintaining the integrity of our legal system,

The Associated Press

MIKE CONNELLY

MIKE CONNELLY

The Sarasota Herald-Tribune

The Sarasota Herald-Tribune

The Sarasota Herald-Tribune

The Sarasota Herald-Tribune

The Sarasota Herald-Tribune

The Sarasota Herald-Tribune
From: Winsor, Deb
Sent: Tuesday, November 02, 2010 2:16 PM
To: Davis, Chris; St John, Paige
Subject: FW: Letters

Fyi – just passing along letters that the Ledger rec’d on insurance stories. I don’t recall if we rec’d same letters.

From: Devore, Lenore
Sent: Tuesday, November 02, 2010 9:36 AM
To: Connelly, Mike; Winsor, Deb
Subject: Letters

Hi Mike and Deb,

I wasn’t sure who to send these to, but they are letters to the editor we got on the insurance package. The first one mentions factual errors, so I wanted to be sure you saw these. If you run any corrections based on these, or any other part of the series, would you let us know as we ran everything.

Thanks,
Lenore

PS: Will be at your paper on Thursday morning – 10 until noon-ish. Hope to see you then.

X

Your Oct. 23 article ‘Florida's Hurricane Insurance Premiums Largely Determined Overseas' draws some useful attention to the often misunderstood world of reinsurance but makes several significant factual errors in the process. Most importantly, perhaps, the article's core allegation that Floridians have 'never before' paid premiums at the levels they do and 'never before received so little benefit' for it is simply false. In fact, Florida insurance premiums have fallen 15 percent since 2007. Likewise, Floridians have collected billions for reinsurers. During the last bad storm season, Floridians and residents of other Gulf coast states collected over $20 billion in payments from Bermuda reinsurers alone. This isn't a small amount. Without offshore reinsurance, indeed, it's unlikely that private homeowners' insurance would exist at all in the State of Florida. The problems of Florida's homeowners' insurance market aren't the result of rapacious offshore reinsurance companies but, rather, a system that has persistently over-regulated the rates that insurers charge and mandated their purchase of underfunded taxpayer reinsurance from a state agency, while abdicating the state's responsibility to ensure that those same insurers remain solvent and able to pay claims.

Florida's insurance system is badly broken, but offshore reinsurers aren't the problem.

CHRISTIAN R. CAMARA

Director
Florida Insurance Project
The Heartland Institute
Tallahassee

X

The recently published articles, 'Florida's Hurricane Insurance Premiums Largely Determined Overseas' of Oct. 24 and 'Bermuda Controls Floridians' Hurricane Insurance Rates' of Oct. 25, fail to address Florida's fundamental problem. Florida is the world's peak disaster zone but the full risk is not priced into insurance premiums. Under realistic disaster scenarios, Florida's insured losses could exceed $100 billion, with an average, annual basis of
$9.7 billion. Insuring Florida's wind risk in state-sponsored entities is neither practical, nor prudent. Florida's government-run insurance plans cannot do so with their limited funds. Consumer taxes on insurance premiums to pay for the 2004 and 2005 hurricane season for state-sponsored Citizens Property Insurance Corporation and the Florida Hurricane Catastrophe Fund are expected to continue through at least 2016. In contrast to tax-backed bonds for state insurers that burden consumers and businesses, a robust private insurance market backed by payments from global reinsurers provides an economic stimulus as the state and its residents seek to recover from catastrophes.

Private reinsurers have provided outside capital to new insurers, providing much-needed competition in the homeowners' insurance market. It is essential insurers and reinsurers make a profit in most years to pay for massive losses that happen less frequently. The articles do readers a disservice by presenting data starting from 2006, ignoring reinsurers' record of payments in prior years. In the U.S. alone, reinsurers paid in excess of $53 billion (about 45 percent) of the $120 billion of losses from terrorism in 2001, and hurricanes in 2004, 2005 and 2008. In addition, reinsurers paid record catastrophe losses in the first half of 2010 and reduced prices for Florida risk in June. By balancing Florida's risk against the risk of other domestic and international catastrophic risks, reinsurers help insurers transfer Florida's risk to global markets at a lower overall cost.

FRANKLIN W. NUTTER
President
Reinsurance Association of America
Washington
November 11, 2010
Paige St. John
Sarasota Herald Tribune
Via Email

Subject: October 25 Bermuda Reinsurance Story

Dear Paige:

I’d like the opportunity to talk to you to express my concern about this story and related material which was published. I realize you’ve already had a conference call with Jim Massie on this, but I’d like to talk about the concerns I have about some of the statements you wrote as fact which are either incorrect or one sided in the presentation. I’ve been traveling outside of the US for three weeks and will be back in Washington on November 12.

More than 30 reinsurers receive more than $20 million from the Florida property insurers for catastrophe reinsurance. That is a diverse group of reinsurers and an indicator of a competitive market. The reinsurance market is highly competitive--there is ample evidence of this. The 2008-2010 market conditions are evidence of the competitive benefits accruing to Florida consumers from competitive reinsurance markets. Plus there are other forms of protection, derivative products and catastrophe bonds. An insurer looking for risk protection can choose from a number of options. It is incorrect to describe this as a market driven by a handful of players. If an insurer’s capital base is large enough, the insurer often chooses to self insure for this risk – another option available to some insurers in the market.

Where there is concentration in this market, it is in the broker community – three very large reinsurance brokers. But oddly enough, this works to the ceding insurer’s advantage since the brokers have great leverage over the reinsurers to play ball to meet the brokers’ clients’ needs. The brokers have a fiduciary responsibility to the ceding insurer client. They work hard to get the best deal for the client; they put enormous pressure on the reinsurers to drop prices and expand coverage to meet the client’s needs. They drive a hard bargain. Reinsurers are dependent on the broker for all business opportunities, so the reinsurer has to play ball with the broker. In addition, the broker works to distribute business to multiple reinsurers via syndication. Your story on this point presents an inaccurate conclusion about syndication. The broker uses a syndication vehicle to build capacity for the client and to promote competition in the market and prevent any one reinsurer from getting too much of the business. In addition, the broker serves to spread out risk to multiple parties and this minimizes “counter party credit risk” for the ceding insurer. Primarily, though, the syndication approach promotes a competitive market by making sure multiple reinsurers get a piece of the action. Many reinsurers get less of
the business they otherwise would want, because the broker is trying to include as many reinsurers as possible for the reasons noted.

You made an example out of a case where if there was a gap in the coverage program, that the last reinsurer to join the syndication can set the price and terms and force up prices on the program. This is a mistaken conclusion. If there is a coverage gap and the last reinsurer wants to raise prices as its condition of filling the gap, the ceding insurer and the broker simply say: “thanks, we don’t need you.” Since most of the reinsurers would be willing to write more coverage anyway, the business is usually simply redistributed to the other players already committed to the program. Alternatively, if that is not possible, the ceding insurer and the broker just leave the reinsurance program with a coverage gap – there is no reason they would allow one party to set terms that are adverse to the ceding insurer’s interests. Finally, the broker could write a separate contract for the layer with the reinsurer that is the hold out. The situation that you described is such a rarity that it is hardly worth noting. In summary, the syndication market provides these benefits to Florida’s ceding insurers:

1. It minimizes the counter party credit risk, the risk of the reinsurer defaulting and bringing the insurer down with it
2. It promotes a competitive market by preventing a few reinsurers from obtaining the largest amounts of capacity on a single contract
3. It increases the broker’s leverage over the reinsurers; leverage which the broker uses to benefit its client and meet its fiduciary obligation to deliver the best terms to the client.

With regard to the errors with regard to the Bermuda system of solvency regulation I understand you’ve seen some of the correction material: my letter to the editor; the RAA fact sheet; and a letter/or conversations with the Bermuda Monetary Authority. I have highlighted in yellow on the attached copy of your story some of the elements that I believe merit correction.

I have disagreements on other matters in your reinsurance stories, but I wanted to point out the mistaken conclusions on the syndicated reinsurance markets and call attention to the need to correct the record with regard to the outdated and incorrect description of the Bermuda insurance regulation for the internationally active insurance groups represented by ABIR.

We spent a good deal of time on the phone several years ago when you were researching these stories and I’m surprised we didn’t have more recent contact prior to publication. If you are working on additional stories I will make time for conversations with you.

Sincerely,

Bradley L. Kading
President and Executive Director

Cc: Chris Davis
Chris.Davis@HeraldTribune.com
Mr. Serge Schmemann  
Editorial Page Director  
International Herald Tribune  

November 9th 2010

Via e-mail: letters@ihnt.com

Dear Mr. Schmemann,

Re: Article Regarding Bermuda Reinsurance Coverage for Florida Market

I am writing regarding the article that appeared recently in the International Herald Tribune entitled, “How Bermuda rigs insurance rates in Florida”, which contains several inaccuracies regarding the Bermuda Monetary Authority and insurance regulation in Bermuda. We are following up with the information below in the interests of accuracy:

Record-keeping requirements/disclosure

All Bermuda-licensed insurers and reinsurers must file annual audited reports to the Bermuda Monetary Authority, contrary to what is stated in the article.

As regards public filings, in keeping with its risk-based regulatory approach, the Authority currently requires Bermuda’s largest (re)insurers to file public general financial statements. We are extending this requirement to other segments of the market on a phased basis, to ensure an orderly transition to this enhanced obligation.

Licensing process

The Authority’s in-house Assessment and Licensing Committee (ALC) reviews, and approves as appropriate, licensing applications. The ALC comprises senior members of the Authority’s supervisory and legal departments exclusively. There are no industry participants on the committee.

The ALC review involves a rigorous, risk-based vetting process for company authorisations and licensing applications, which includes criminal background checks and requiring details of the owners and capital sources for prospective companies.

This process is built on Bermuda’s long-standing Know Your Customer standards, stemming from the jurisdiction’s commitment to permitting only quality business to conduct business in or from Bermuda.

As Bermuda’s integrated financial services regulator, the Authority is able to employ centralised review of licensing applications, ensuring that the process is both effective and efficient.

Solvency standards

The Authority has implemented enhanced risk-based capital standards for Bermuda insurers. Under these standards Bermuda’s insurers are subject to detailed solvency requirements, determined and increased as appropriate according to the nature and risk of the business they conduct.
This regime builds on strict solvency requirements the Authority has historically applied to insurers. These requirements have contributed to a record of on going policyholder protection and efficient payment of claims by the Bermuda market.

Bermuda’s standards are fully compliant with international solvency standards set by the International Association of Insurance Supervisors (IAIS). The IAIS is the global standard setter for insurance regulation. Therefore the IAIS, not rating agencies, provide the most appropriate benchmark for setting such standards.

**Bermuda’s risk-based insurance regulations**

Bermuda has built a reputation as a quality jurisdiction that is well-regulated. This jurisdiction’s regulations are well-developed, with high standards that are clearly articulated to the market via legislation and a specific code of conduct.

The Bermuda Monetary Authority has ensured Bermuda’s regulatory framework is effective, practical for Bermuda’s predominantly wholesale insurance market and also consistent with international standards. Our risk-based regulatory approach ensures that progressively rigorous requirements are placed on (re)insurers based on their risk profile, i.e. the nature, scale and complexity of their business.

This approach has been recognised and endorsed globally, including most recently the International Monetary Fund, which in their latest review of Bermuda’s financial regulations found them to be highly compliant with international standards.

The Authority also notes the work conducted by the Bermuda Government that demonstrates this jurisdiction’s active commitment to international cooperation on tax matters.

Bermuda participated fully in the Organisation of Economic Cooperation and Development’s (OECD) development of a model tax information exchange agreement (TIEA) that was adopted in 2002. Bermuda’s leadership role in establishing the OECD Model TIEA was assisted by its experience as a partner of the United States in a long-standing TIEA that was signed in 1988. Bermuda currently has TIEAS in place with 22 jurisdictions.

Similarly, as part of Bermuda’s commitment to a high level of cooperation with our supervisory counterparts overseas, the BMA has signed a Memorandum of Understanding (MoU) with the Florida Office of Insurance Regulation. This information exchange agreement is one of 16 such MoUs that the Authority has established with other international regulatory agencies.

We hope these facts assist you in gaining an accurate understanding of the Authority and insurance regulation in Bermuda. Please note that the Authority’s role as this jurisdiction’s independent financial services regulator is to support Bermuda’s globally recognised good standing by applying high standards in regulation. This mandate drives the work of our staff as well as our Board, whose members bring senior experience and expertise from across the financial services sector.

We will be happy to ensure your reporter is provided with regular updates on developments in Bermuda regulation. Should you be interested in publishing any future articles about Bermuda and its insurance regulations, we would be very pleased to provide you with additional information.

Yours sincerely,

[Signature]

Pat Phillip-Basset
Deputy Director
Corporate Governance and Communications
Bermuda Monetary Authority
Editor
Sarasota Herald Tribune

Via e-mail: letterstotheditor@heraldtribune.com

November 10th 2010

Re: Articles Regarding Bermuda Reinsurance Coverage for Florida Market

I am writing regarding an article that appeared recently in the Sarasota Herald Tribune, “How Bermuda rigs Insurance Rates in Florida” – October 25th, which contained inaccuracies regarding the Bermuda Monetary Authority and insurance regulation in Bermuda, and also related articles "Property insurers sending billions overseas" - October 24th, “Bermuda's reinsurance record is not spotless” – October 25th. In the interests of accuracy we are following up with the facts below:

Record-keeping requirements/disclosure

All Bermuda-licensed insurers and reinsurers must file annual audited reports to the Bermuda Monetary Authority, contrary to what is stated in the article.

As regards public filings, in keeping with its risk-based regulatory approach, the Authority currently requires Bermuda’s largest (re)insurers to file public general financial statements. We are extending this requirement to other segments of the market on a phased basis, to ensure an orderly transition to this enhanced obligation.

Licensing process

The Authority’s in-house Assessment and Licensing Committee (ALC) reviews, and approves as appropriate, licensing applications. The ALC comprises senior members of the Authority’s supervisory and legal departments exclusively. There are no industry participants on the committee.

The ALC review involves a rigorous, risk-based vetting process for company authorisations and licensing applications, which includes criminal background checks and requiring details of the owners and capital sources for prospective companies.

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Yours sincerely,

Pat Phillip-Bassett
Deputy Director
Corporate Governance and Communications
Bermuda Monetary Authority
There will be blood

F ormer San. Alan Simpson, a Vietnam Ve-

riment, has been hit with a double whammy. President Barack Obama appalled.

The White House's decision to reject his request for a new role on the Federal Reserve Board of Governors has left the two men in a state of mutual dread. In a recent interview, Simpson said, “The Fed’s leadership has been astonishingly weak. They’ve taken on the role of political appointees, not policymakers. The Fed is no longer the independent institution it once was.”

Simpson’s views are not shared by all Republicans. House Speaker John Boehner has said that Simpson’s recommendations are “a travesty” and that he is “a political hack.”

Meanwhile, the Senate Banking Committee and assistant to the President for legislative affairs, is expected to vote on whether to confirm the Fed’s new chairman, Janet Yellen, before the end of the year. The vote is expected to be close, with Republicans arguing that Yellen is too ideologically aligned with President Obama and Democrats arguing that she is a skilled and experienced leader.

The debate over the Fed’s leadership continues, with some arguing that the institution needs a complete overhaul and others suggesting that reforms are needed to ensure its independence and effectiveness. The future of the Fed remains uncertain, as the country grapples with a growing debt crisis and the need for sustained economic growth.

In a separate development, the U.S. Senate is expected to confirm the appointment of former Massachusetts senator Scott Brown to the Fed’s Board of Governors. Brown, who was appointed by Senator John Kerry (D-MA), has been a vocal critic of the Fed’s policies and has expressed concern about the potential for “political appointees” to influence the institution’s independent decision-making process.

The appointment of Brown to the Fed’s Board of Governors is likely to further fuel the debate over the institution’s leadership and the need for reforms to ensure its independence and effectiveness.

Economists have warned that the ongoing debate over the Fed’s leadership could have serious implications for the country’s economic prospects. With the economy still struggling to recover from the recent recession, any steps that could undermine the Fed’s independence and effectiveness could have serious consequences.

In conclusion, the debate over the Fed’s leadership continues to be a contentious issue in Washington, D.C. With the country facing a range of economic challenges, it is critical that the institution is able to carry out its mission of promoting economic stability and growth.

The future of the Fed remains uncertain, and it is clear that the debate over its leadership will continue for some time to come. With the economic landscape shifting rapidly, it will be important for policymakers to ensure that the Fed is able to carry out its mission in a manner that is consistent with the interests of all Americans.