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Property insurers sending billions overseas

Reinsurance firms profit as reserves dwindle

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Published: Monday, October 25, 2010 at 1:00 a.m.

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.



STAFF PHOTOS / PAIGE ST. JOHN

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

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, exacerbating widespread policy cancellations. The lost capital also weakened insurance company finances, drained surplus for future storms, and pushed carriers over the edge, giving Florida the highest insurance failure rate in the nation.

The volatile reinsurance market 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 elsewhere in the world.

The costly dependence frustrates those who would try to revive the state's foundering property insurance market.

State Insurance Commissioner Kevin McCarty alternatively has pleaded with reinsurers to play a greater role in Florida and called them "greedy" when they extracted crushing rate hikes.

Former Gov. Jeb Bush set aside his free-market ideology to conclude Florida could not "be at the mercy of people who hope for catastrophes to keep their rates high."

The newspaper learned that Bush secretly spent part of his last year in office seeking an alternative, lobbying his brother in the White House and fellow governors of catastrophe-prone states to create a government substitute.

Four years later, a leader of state insurance agents reached a similar conclusion.

"A large part of Florida's marketplace problems are due to its over-reliance on reinsurance," said Jeff Grady, president of the Florida Association of Insurance Agents.

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

IN ITS TRADITIONAL form, reinsurance was insurance for insurance companies, policies bought in relatively small amounts to protect carriers from the remote chance of a very large disaster.

But in Florida today, and increasingly along the eastern seaboard, reinsurance is on the verge of replacing traditional insurance altogether.

The turning point was Hurricane Katrina.

A month after Katrina, with the storm's cost and death toll mounting, Allstate president Thomas Wilson expressed regrets in an October 2005 quarterly earnings conference call, but said that the nation's second-largest insurer was through with hurricanes.

"We have no moral or legal obligation to provide this kind of coverage to people," Wilson declared.

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

From 2005 to 2008, 2.2 million Florida homeowner policies were canceled or non-renewed. The state-run Citizens Property Insurance for the first time became the largest provider of hurricane coverage in Florida.

With no viable alternative, state regulators and private insurance companies looked to offshore reinsurers to underwrite the risk posed by storms. With a few million dollars in the bank, newly formed insurers could buy large amounts of reinsurance to instantly write billions of dollars worth of coverage.

The new Florida norm are carriers like ACA Home, a tiny St. Petersburg home insurer started after 2005 with funding in part from a Bermuda reinsurer.

ACA Home has no employees and pays an affiliate, American Strategic, to run its business.

Financial filings show reinsurers take 86 cents of every premium dollar ACA collects -- \$9 million of the \$10.5 million it collected in 2009.

The cost for turning over almost all of its risk is high. ACA pays as much as 33 cents for \$1 of protection against the most likely kind of storms, the equivalent of paying \$66,000 a year to insure a house worth \$200,000.

The Herald-Tribune found more than half a dozen Florida insurers paying more than 50 cents for a dollar of hurricane coverage, reinsurance rates brokers say are the highest in the world.

Yet Florida's insurers continue to buy more. They use the premium they collect to purchase additional reinsurance to write more policies, rather than retaining the money to shore up their own capital bases.

From 2004 to 2009, Florida carriers' reinsurance bill nearly tripled, from \$1.4 billion a year to more than \$4 billion.

The portion of homeowners' premium devoted to reinsurance in that time increased from 37 percent to 64 percent, according to the newspaper's analysis of 70 Florida-only property insurers. The national average is only 19 percent.

That in turn drove up the cost of coverage for homeowners. Quarterly premium reports show the average Florida homeowner pays 72 percent more today than in 2003. The average premium has nearly doubled or more in nine coastal counties.

Florida regulators have sanctioned rates as high as \$7,890 to insure a \$100,000 house in Palm Beach and \$13,000 a year for the same abode in the Florida Keys -- making insurance premiums there as expensive as a mortgage.

The change in how Florida's largest insurers handle risk is most dramatic. A state report noted State Farm, Allstate, Universal Property and American Strategic in 2002 spent only 7 percent of their premium on reinsurance.

In 2009, the Herald-Tribune found, the burden was 54 percent.

Annual financial reports show more than 28 Florida insurers devote more than half their premium to external coverage, some to the point of extinction.

"Nobody can stay in business spending that," said Lara Mowery, vice president of Guy Carpenter & Co., one of the chief brokers of Florida reinsurance contracts. "That can't be a sustainable business plan."

FOR A GUT-WRENCHING 48 hours in September 2008, the National Hurricane Center's skinny black line pointed like an accusation at Miami.

Hurricane Ike was barreling through the Atlantic as a Category 4, on a westerly track that had the potential to deliver the long-dreaded sucker punch that would bring Florida to its knees.

As stomachs churned in Florida, a quarter turn around the globe on the balmy Mediterranean, the reinsurance industry welcomed an American calamity.

The financial giants who underwrite the world's risks were gathered in Monte Carlo for their annual Rendez-Vous de Septembre. Amid champagne parties and sailing races, they kept close watch on the advance of the storm.

Profits at that moment were flat and reinsurance rates falling, even in Florida.

By their analysts' calculations, it would take a \$35 billion disaster to turn the market around.

The head of research for a London brokerage sized up the hurricanes circulating in the American Gulf.

"Gustav and Hannah: perhaps unlikely to have a major impact ..." he told financial writers in the plush salon of a Monte Carlo hotel, as they picked over silver trays of tiny lime tarts.

"But Ike ..." he said, turning his attention to the storm worrying Miami, "... depending on which way it goes, it could be a turning point, ladies and gentlemen."

There was nothing in his tone, nor the reaction of those taking note, to reveal they were discussing the decimation of another American city.

There is a perverse tendency for the reinsurance industry to hope for disaster.

The cost of calamity coverage is determined mostly by supply and demand. Big disasters can temporarily dampen quarterly profits and even kill a few unlucky reinsurers, but they drive up demand and draw down capital, shrinking supply.

The result is record profits made on the back of the world's biggest catastrophes -- Hurricane Andrew, 9/11 and Hurricane Katrina.

The macabre sentiment pervading Monte Carlo in 2008 was parodied a few mornings later at the Cafe de Paris, where reinsurance brokers massed 20-deep for preliminary negotiations on the hurricane contracts for which Floridians would pay the next year.

"Industry mourns the passing of Gustav," joked a headline in the Rendez-Vous edition of the normally sedate Insurance Day.

By missing New Orleans, the trade journal quipped, the hurricane had "failed to destroy billions of dollars worth of energy infrastructure and make millions of uninsured poor people homeless.

"An executive from a Bermuda start-up said he had lost everything as a result of the non-storm ...

"I've got everything riding on a big one."

THE REINSURANCE INDUSTRY is much like the high-priced casino where reinsurers gather every fall.

The money on the table comes from the world's richest investors -- institutional funds, global bankers and, increasingly, U.S. hedge funds.

The objects of their betting are hurricanes, typhoons and earthquakes, as well as pandemic diseases.

Their biggest wager is Florida.

The state has more than \$2 trillion of property parked on the edge of the world's hottest hurricane zone. No other insured peril in the world comes close in potential losses.

"Florida is the, by far, the number one 'cat' risk in the world. Bar none. By a factor of two," said Harbor Point Re vice president Greg Richardson.

But the risk of a hurricane accounts for only a fraction of the price reinsurers charge. The majority of the cost is driven by how much profit investors demand, and whether insurers are desperate enough to pay those rates.

"It's like a game of poker," John DeMartini, vice president of risk for Towers Watson, a national broker of reinsurance contracts, told the Herald-Tribune.

The game is uneven.

Florida insurers are particularly needy buyers, hence they have little choice to refuse what reinsurers demand to be paid.

"It is a diabolical situation insurers find themselves in," DeMartini said.

On average, the Herald-Tribune calculated, reinsurers charge five times more than the actuarial risk of loss.

The translation for Florida property owners: For every \$1 in hurricane risk to their home, they pay another \$4 for the reinsurer's profit. In other words, if a reinsurer determines a home is likely to sustain \$2,000 in damage in a year, it will charge \$10,000 to cover that home.

In reinsurance, such math is unquestioned. It is not "undue profitability" but "the cost of capital," concluded an industry-funded study by the vaunted Wharton Risk Center at the University of Pennsylvania.

"Insurers need considerable capital to supply this insurance and the cost of that capital is included in the premium," they note.

After Hurricane Katrina, some of the highest rollers providing \$33 billion to recapitalize the reinsurers of Bermuda included Lehman Brothers and Goldman Sachs, and private investors recruited 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 mortgage-backed securities. They sought return percentages from the mid-teens to high 20s, Mike Millete, 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 Validus 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 percent return.

Being in Bermuda, the profits were tax-free.

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

"Putting aside the tremendous human cost of natural catastrophes, as an investment category, cat risk is actually quite wonderful," Greg Richardson, vice president of Harbor Point Re, told his peers at a summit in 2008.

AS INSURERS SPEND more on reinsurance, they have less money 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 watchers, it is weakening.

The surplus held by Florida-based insurers in 2003 was \$2 billion. 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 dollar of brick and shingle they insured.

Now it is 42 cents.

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

And it comes despite record revenues. Insurance premiums statewide have climbed from an average \$850 per home in 2003 to \$1,458 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 actually dropped.

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

Since 2009, 10 carriers have fallen 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, particularly Katrina, left the Bermuda reinsurers that provide most of Florida's hurricane coverage with net losses of \$2.1 billion.

Those same reinsurers reported profits of \$11.6 billion in 2006 -- a record -- and \$11 billion in 2007.

Those running the companies fared well, too.

Executive pay for the top five officers at Renaissance Re -- Florida's biggest reinsurer -- quadrupled from \$6 million in 2005 to \$28 million in 2009. CEO Neill Currie's latest \$7.6 million compensation 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 profits 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 convention in Monte Carlo.

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

There is a single scheduled event -- a poorly attended speech on some aspect of the market.

Tradition demands a 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 a few contracts get signed in this open air market.

The bulk of the week is devoted to "building relationships," a function 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 tourists who had nowhere to go.

Brokers huddled over spreadsheets beneath bronze busts of Louise XIV or scribbled notes against a grand piano or beneath a Greek nude. The bigger reinsurance houses held forth from private salons and yachts tied up in the harbor.

"Uncivilized, isn't it?" a Bermuda broker remarked unbidden, taking refuge in a slice of shade at the cafe as he awaited a turn at the strangely public discussions, the subject of which was death and destruction.

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

The brokers from Guy Carpenter held a huge party in a ballroom beneath a ceiling papered in gold, lasers casting corporate logos atop the bathing nudes 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.

On the next block, top-hatted magicians on stilts greeted delegates who entered through a veil of tiny bubbles, tossing firecrackers over their heads.

The impeccably dressed hosts from Dubai handed out party favors of oversized billfolds, while a bus crouched at the curb to ferry brokers to the next soiree.

On the terrace, a trio of sequined starlets slid among the strolling financiers, trailed by backup dancers.

"They tried to make me go to rehab," they crooned to the drinking brokers.

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

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