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FLORIDA'S INSURANCE NIGHTMARE

BY PAIGE ST. JOHN

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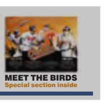

MEET THE BIRDS
Special section inside

An 8.8 quake rattles Chile

TSUNAMI: Warnings went out across the Pacific; no word of damage

By JONATHAN FRANKLIN and MARY BETH SHERIDAN
The Washington Post

SANTIAGO, Chile — One of the most powerful earthquakes on record jolted central Chile on Saturday, smashing homes and bridges and unleashing tsunami waves that coursed across the Pacific, prompting alerts in Hawaii and dozens of countries. At least 214 people have died in the coastal South American nation.

Waves generated by the 8.8-magnitude quake started to smack onto Hawaiian beaches about noon local time, but they were smaller than the 6-foot monsters scientists had feared. The water surged more than three feet in Kahului Bay in Maui before the tsunami warning was canceled in the early afternoon, officials said.

There were no reports of flooding or damage.

By Saturday evening, the Pacific Tsunami Warning Center had lifted the tsunami warning for almost the entire Pacific.

"It's a big relief," said Jenifer Rhoades, the National Weather Service's tsunami program coordinator. "It was pretty scary. We're glad it turned out to be an event where there wasn't tremendous impacts in terms of loss of life."

The predawn quake that hit Chile was far stronger than the temblor that rocked Haiti last month. But far fewer people died in Chile because the quake

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HERALD-TRIBUNE INVESTIGATION

WEAK INSURERS PUT MILLIONS OF FLORIDIANS AT RISK

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

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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.**

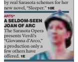
ONLINE: Detailed financial measures for more than 50 Florida insurers at heraldtribune.com/floridainsurance.

COMING SOON: Dozens of Florida insurers are making themselves rich instead of protecting policyholders.

INSIDE

LOCAL
RESCUERS SAVE CHILDREN
Investigators say the mother was apparently trying to drown the youngsters in a frigid pond. **1B**

BOOKS
A NOVEL'S INSPIRATION
Author Leslie Glass is inspired by real Sarasota schemes for her new novel, "Sleeper." **10E**



ARTS*
A SELDOM-SEEN JOAN OF ARC
The Sarasota Opera presents Verdi's "Giovanna d'Arco," a production only a few others have offered. **1E**

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SNN LOCAL NEWS 6
TOO COLD TO ROW
We'll show you how cold weather ruined a regatta for hundreds of rowers Saturday.

OUR 85TH YEAR NUMBER 144
6 SECTIONS

Medicaid complicates Florida budget

HEALTH CARE: Rolls increase with job losses, and some federal funding is in doubt

By LLOYD DUNKELBERGER
H-T Capital Bureau

TALLAHASSEE — The Florida Legislature faces a health care crisis disguised as budget crisis.

As leaders in Congress wrestle with health insurance reform, the consequences of millions of uninsured Floridians looms starkly over the 2010 Florida legislative session, which begins Tuesday.

The state faces a $3 billion budget shortfall, and Medicaid is one of the main reasons for it.

More than one-quarter of the cash-strapped $66 billion budget now goes to Medicaid and the cost is rising so fast that within a decade more than one-third of the budget will go to paying medical care for the poor and disabled, unless changes are made.

The immediate problem facing lawmakers is that the economic recession has swelled the Medicaid rolls to 2.7 million Floridians — creating more than an $800 million deficit that will have to be made up in the new budget. Additionally, nearly another $1 billion in federal Medicaid funding remains in doubt next year, awaiting Congressional action to extend the extra money through

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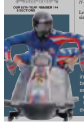
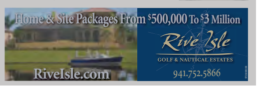
SESSION PREVIEW
Major issues and key players in the 2010 Florida legislative session, plus H-T Capital Bureau reporter Lloyd Dunkelberger's take on what is likely to happen. **Pages 20-21A**



USA GOLD
The victory in four-man bobsledding ended a 62-year drought for the U.S. in the event. **1C**



Shaky property insurers put millions of Floridians at risk

INSURANCE *from 1A*

put state residents farther out on a limb.

- Larger dangers loom. Despite rising property values, one in three Florida carriers has decreased the cash set aside for storms.

The Florida-only carriers that provide the majority of hurricane coverage in this state now stretch their limited cash nearly twice as far as they did before 2004. They do it by buying a form of backstop insurance, called reinsurance, that is supposed to kick in and prevent insurers from failing when major catastrophes strike.

But insurers still must have their own money to pay what amounts to a deductible. And after every storm they need cash to operate and pay claims until they can collect on their backstop policies.

Experts point out that even companies with the best reinsurance policies can fail if they experience cash-flow problems.

In simplest terms, the average Floridian with a $350,000 house is insured by a company with less than $750 in hand to pay for that home. By contrast, the average carrier had $1,300 in 2003.

That same year, Allstate and other well-funded insurers had nearly $4,000 banked for the same risk.

"It is the Florida Ponzi Scheme," said Miami agent Phil Lyons, secretary of the Independent Insurance Agents of South Florida.

Regulators, insurance executives and industry lobbyists argue that the system, perhaps flawed, is all that Florida has to fill the yawning hole left by the mass exodus of national insurers.

"What were the options?" asked Sam Miller, vice president of the Florida Insurance Council, the industry's largest trade group in the state. "I don't think any other plan would have worked."

Miller

Yet among insurance insiders there is unease and growing alarm.

"There should be bells and whistles going off everywhere," said Jeff Grady, president of the Florida Association of Insurance Agents, where chasing down rumors of failing insurers has become the trade group's recent obsession.

"On the surface it may appear things are OK, but below the surface, things are really troubling."

WHY UPSTART INSURERS DOMINATE IN FLORIDA

Beginning with Hurricane Andrew in 1992 and accelerating after Katrina in 2005, Florida's property insurance market changed dramatically.

State Farm and Allstate, combined protectors of one-third of Florida homeowners before 2004, led a wave of withdrawals, followed by Nationwide, USAA, Hartford and Travelers.

In their place arose what insurance expert Robert Klein, director of the Center for Risk Management and Insurance Research at Georgia State University, calls the "Florida-zation of cat risk."

These are the insurance companies that only do business in Florida, taking an all-or-nothing gamble on the state's weather.

In 1992, these concentrated risk-takers insured just 6 percent of Florida. Today, including the Florida-only subsidiaries of national insurers, they cover 71 percent.

Insurance, historically, has been an industry built on huge reserves. Firms amass a foundation of capital, then risk that money by promising to repay homeowners in the event of losses.

Profits, historically, came from the interest earned on the money that sits waiting to be paid out.

All that has changed. In Florida, insurers are now risk-brokers, players with relatively little money and a lot of leverage. In place of huge cash reserves, they have reinsurance — essentially insurance policies for insurance companies — that pays off in a major disaster. Those policies are so costly that most companies have little money left to build reserves.

Klein

Reinsurance enables fast growth. Instead of building up a company slowly by amassing enough 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 just as quickly, putting thousands of Florida homeowners at risk.

Even in 2000, before the explosion of single-state carriers in Florida, 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 "thinly capitalized, opportunistic insurers."

NOT ENOUGH MONEY TO PAY OFF HOUSE FIRES

Miami businessmen Alexander Anthony and Albert Fernandez sold their security guard business to launch Northern Capital Insurance Group.

They rocketed from $476,000 in revenue in 2006 to more than $95 million by 2008, adding a second carrier, Northern Capital Select, in the process.

Last September, Inc. Magazine heralded the company as "America's Fastest Growing Private Company."

The award came with publicity and a congratulatory letter from Gov. Charlie Crist, thanking the carrier for its phenomenal growth.

But the meteoric rise also came at great risk, mostly to customers.

State records show the group has the most concentrated roll of the dice in all of Florida.

Three of every four policies written by the companies were in a 143-mile stretch of the Atlantic coast — Miami to Palm Beach — that presents the single greatest hurricane threat in all of America. For as far back as the records go, a Category One storm has rolled ashore here at least every four years.

The exposure of these two insurers during the 2009 hurricane season was twice that even of Citizens Property Insurance, the state-run company that covers homes deemed too risky by other insurers. Six other Florida carriers are in the same boat, carrying greater concentrations of risk in Miami than Citizens does.

"It scares me. I fear when the next storm comes. I fear if it lands anywhere near here," said Dulce Suarez-Resnick, a Miami agent who is past president of the Latin American Association of Insurance Agencies.

While Northern Capital Select had the highest concentration of hurricane 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 had greater assets, but also more risk, leaving it at the start of 2009 just above what state laws required for its exposure.

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

They did it with less than $20 million.

The companies bridged the gap by buying huge amounts of reinsurance from overseas investors willing to gamble against a storm. According to third-quarter financial statements, the carriers by September 2009 spent $64 million of the $94 million in premium they collected buying that protection.

Between what the insurers paid for reinsurance and what they paid in other overhead costs, contracts filed with regulators show, there was not enough money left to pay claims.

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

But regulators did not warn consumers about the risk.

Instead, the agency in August secretly prepared an order placing the company under administrative supervision.

While Northern Capital basked in the glow of its Inc. Magazine publicity and hit the financial markets hoping to raise $12 million, OIR sought to require the company to buy more reinsurance and stop writing new business in Miami-Dade, Broward and Palm Beach counties.

An unsigned copy of the confidential order was obtained by the Herald-Tribune. OIR officials refused to acknowledge its existence, and calls to Northern Capital's owners were not returned. President Wayne Fletcher and vice president Will Brauer did not respond to repeated calls.

By October, Northern Capital began retrenching, merging its two insurers into one. In February, the company lost its "A-exceptional" financial rating from Demotech, after the rating agency claimed deadlines to raise additional cash and come up with a new business plan passed unmet.

The company remains in business.

BELOW: Albert Fernandez, left, and Alexander Anthony, founders of Northern Capital Insurance, were featured in the September 2009 issue of Inc. Magazine. At that time, the insurer was named fastest-growing private company in the U.S.

LEFT: Anthony, left, and Fernandez, in a photograph taken by Inc. Magazine.

PHOTO PROVIDED BY JEFFERY SALTER | REDUX

IN THE RED ZONE: 42 INSURERS AND RISK

The financial troubles of Florida insurers go far beyond Northern 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 disclosure, the Herald-Tribune turned to measures commonly used by those in the industry, from agents who place your policy to regulators who police the business, to academics and consumer advocates.

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

They agreed, however, that there are several important indicators of financial weakness and they provided benchmarks for each. They include: low levels of savings, comparatively high amounts of risk, an over-reliance on reinsurance and a heavy concentration of customers in one geographic area.

The Herald-Tribune found that about 30 companies out of more than 70 reviewed appear fiscally sound. Forty-two failed at least one of the benchmarks.

That means one in three privately insured homes in Florida — some 2 million families — relies upon an at-risk insurer for hurricane protection.

Fourteen of those insurers tripped two or more of the four warning flags. Of the three companies 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 insurance brokers, questioned if the Florida insurance market is, in its words, "at the tipping point."

In a report to its insurance company clients, the brokerage estimated that one in 10 Florida carriers has insufficient capital to weather a catastrophe. Not one of the 150 national property insurers reviewed by Aon had the same risk.

Bryon Ehrhart, CEO of Aon Analytics in Chicago, said, "Florida is operating at a much higher leverage rate than the rest of the nation."

See INSURANCE on 12A

SIX INSURERS WITH RED FLAGS

HOMEWISE PREFERRED
Started: 2007
Policies: 127,000*
Funds set aside: $19 million**
Amount insured: $41 billion*
Risk factors
Highly leveraged: $1 in capital for $2,145 insured.
Low regulatory score: 246, close to state action level of 200.
About the company: This Florida-focused insurer, based in Tampa, in February relinquished its financial strength rating from Demotech. The parent corporation says it will shut down Preferred and move those policies to its other carrier, HomeWise, covering the combined exposure with $20 million in capital. The HomeWise companies share 85 percent of their business and hurricane risk with reinsurers in Bermuda and the Cayman Islands. Preferred was among the most leveraged companies in Florida.

MAGNOLIA INSURANCE
Started: 2008
Policies: 82,000*
Funds set aside: $16.4 million*
Amount insured: $17 billion*
Risk factors
Highly leveraged: $1 in capital per $1,058 insured.
High risk concentration: Two of five homes insured are in Dade and Broward counties.
About the company: Formed out of the founder's Key Biscayne home, several insurance agents said they had trouble even contacting the company for their clients. "They didn't even have an office. They didn't even have a Web site. They didn't have a phone," said Miami agent Dulce Suarez-Resnick. Company president Henry James Irl got licensed to open Magnolia despite recent court orders garnishing his wages over credit card debts. Regulators put the company under administrative supervision and required Irl to resign in December.

NORTHERN CAPITAL INSURANCE
Started: 2007
Policies: 70,000*
Funds set aside: $18.7 million**
Amount insured: $23 billion*
Risk factors
Highly leveraged: $1 in capital per $1,224 insured
High risk concentration: Two of three policies in Miami-Dade, Broward and Palm Beach counties
Low regulatory score: In 2008, Northern Capital scored 216, within 50 points of required state action. Select's score was even lower.
About the company: Based in Miami, this Florida-only company was created by two men who sold their security-guard business to form two insurers. It was lauded in 2009 by Inc. Magazine as the fastest-growing private company in the U.S. Northern Capital Select began shutting down in October. The group's other insurer lost its Demotech rating last week.

PEOPLE'S TRUST
Started: 2009
Policies: 34,000*
Funds set aside: $9.6 million**
Amount insured: $8.4 billion*
Risk factors
Low capital: Less than the $10 million recommended by state regulators.
Low regulatory score: 228, near state action level of 200.
About the company: This Boca Raton-based insurer operates exclusively in Florida and was formed by retired office copier supplier Mike Gold with investments from OPI Products nail polish producer George Schaeffer. The company was suspended by regulators in 2009 for numerous alleged business practice violations and inadequate hurricane coverage. It has been re-launched under a state consent order.

SUNSHINE STATE
Started: 1998
Policies: 73,000*
Funds set aside: $9.4 million**
Amount insured: $32 billion*
Risk factors
Low capital: Less than the $10 million recommended by state regulators.
Highly leveraged: $1 in cash reserves per $3,429 insured, among the most leveraged in Florida.
About the company: This Florida-focused insurer based in St. Augustine writes a small number of policies in South Carolina. In 2008, it nearly exceeded the state limit on the amount of policies permitted for its capital.
It is owned through a chain of ventures by an investment group headed by Tal Piccione, CEO of U.S. Re Corp., a New York reinsurance brokerage.

SOUTHERN OAK INSURANCE
Started: Nov. 2004
Policies: 50,000*
Funds set aside: $11.6 million**
Amount insured: $13 billion*
Risk factors
Low regulatory score: Southern Oak achieved a barely passing score of 201 after investors in 2008 paid in $200,000 more. In 2009 they contributed another $3 million, bringing surplus to $11.6 million, in the range of what regulators consider a realistic minimum for Florida insurers.
About the company: Most of the business in this Jacksonville-based insurer is from Citizens. Southern Oak's president, Tony Loughman, is the ex- underwriting officer for Citizens. The firm posted insurance losses of $6 million in September.

* Figures as of June 30, 2009
** Figures as of September 30, 2009

Just what makes an insurance company strong?

Much of the financial information needed to judge an insurance company is secret or difficult to find and interpret. But most experts agree there are some simple things to guide homeowners:

FIND AN INSURANCE AGENT YOU TRUST

They generally have access to information and an understanding of how to use it that most homeowners do not.

BE WARY OF EXTREMELY LOW PRICE QUOTES

If a company, especially a new insurer, quotes premiums far below what other companies offer, it could be a sign of trouble. Some companies have been known to discount rates below what is feasible to gin up new business. If a storm comes, they may not have enough money to survive.

ASK HOW MUCH SURPLUS THE COMPANY HAS

The minimum in Florida is $4 million, but experts warn even $12 million is a drop in the bucket when gambling with hurricanes. Reinsurers who underwrite Florida companies consider $25 million to $50 million to be a safe minimum.

BORING IS GOOD

Fast growth is not. Experts ranging from A.M. Best to the Insurance Information Institute warn that poor decision-making about what risks to insure and how much to take on are more common causes of insurance insolvency than natural disaster. They favor stable companies with consistent results.

WHERE DOES THE MONEY GO?

Ideally an insurer uses its excess earnings during non-hurricane years to build up for the inevitable storm — not to pay its investors excessive stock dividends. A growing surplus fund is a sign that, as one risk management expert says, "their heart is in the right place."

WHO ANSWERS THE PHONES?

Florida has given rise to a growing number of "virtual" insurers, corporate management shells that outsource most of the actual work of insurance. Agents have complained that it is difficult to get information from some of these companies.

This Key Biscayne house at 260 Glenridge Road was used by Henry James Irl to launch Magnolia Insurance. Insurance agents say the company was run by Irl from his home while it insured billions of dollars in property.

STAFF PHOTO / SELINA ROMAN

Shaky insurers put millions in Florida at risk

INSURANCE *from 11A*

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 Florida 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 FIGA Operations Manager Tom Streuckens.

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 victims 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 claim estimate from the state fund. One is unable to rebuild. Her unlivable, damaged town house sits unrepaired 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 callous indifference."

Even if the program worked perfectly as a backstop, 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 insolvencies. The result would be homeowners receiving only partial payment, then waiting months, if not years, for the rest.

Streuckens 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 borderline amounts of capital — placing $143 billion worth of homes at risk of being uncovered in a catastrophe.

That is one and a half times the size of the insurance companies that failed following the 2004-05 hurricanes.

BILLIONS 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 loan, 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 from Citizens Property Insurance.

By mid-2008, thousands of South 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 office. They didn't even have a Web site. They didn't have a phone." said Dulce Suarez-Resnick, 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-Resnick 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 supervision and ordered its president to leave.

The December order capped what is possibly the shortest start-to-suspension of a Florida insurance 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 the four-bedroom red-tile roof home of company president Henry James Irl.

Florida law allows state regulators to deny an insurance license to a company whose executives show poor financial credibility. Yet the Office of Insurance Regulation cleared Irl, despite the fact that Miami-Dade County Circuit Court files show he had a history of bad credit card debt.

Court filings from 2006 through 2008 show Irl was sued for $40,000 in unpaid debts and interest, resulting in two orders attempting to collect the money by garnishing his wages at the not-yet operational Magnolia.

The last of those cases was not dismissed until the end of 2008. By then, Irl was running an insurance company responsible for the financial security of 100,000 homeowners with property worth $24 billion.

"How did the state of Florida allow this person to get approved to run an insurance company in the state?" asked Suarez-Resnick.

Suarez-Resnick

Officials with Florida's Office of Insurance Information refused to answer questions about Magnolia, including whether Irl had disclosed his personal financial problems. Irl did not respond to messages left with his company or at his home.

Circumstances surrounding Magnolia's supervision remain sealed under Florida insurance laws that treat regulatory investigations 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 operated through the 2009 hurricane season with no outward sign of trouble.

The only specific information about why Magnolia's operations were seized comes through Demotech, the financial rating firm that suspended Magnolia's "A Exceptional" rating two weeks before regulators stepped in.

With the rating suspension, Demotech explained for the first time that it had been negotiating with Magnolia for months over serious problems with its financing, policy handling and management.

FLORIDA OFFICIALS ASK: WHAT CHOICE IS THERE?

The Office of Insurance Regulation readily acknowledges Florida is in the throes of dramatic change.

From Kevin McCarty, insurance commissioner, to the lowest-level regulators, OIR officials expressed optimism for the market as a whole despite trepidation over the stability of individual insurers.

"You're right. There will be failures," said Robin Westcott, solvency director for OIR's property division. However, she and other regulators said, they believe most of Florida's relatively new insurers will survive and a large portion of the market is strong.

These officials argue the failures are a natural byproduct of the state's need to find new insurers quickly as national carriers dumped hundreds of thousands of customers after 2005.

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

The state has, since 2006, attracted 29 new companies with $509 million in new investment.

"I think it's a success story that we're able to attract new companies that are writing 615,000 policies," McCarty told Florida Cabinet members in August.

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

"It is a difficult marketplace. . . . You're getting to a point where these companies are going to separate themselves as to who can do it successfully and then those that aren't going to," Westcott said in November, following the shutdown of American Keystone.

"All we hear from the Legislature is 'Free Market, Free Market, Free Market,'" Westcott said. "Well, this is a function of Free Market."

SIX INSURERS WITHOUT RED FLAGS

ACA HOME INSURANCE
(formerly Home Pointe Insurance)
Started: 2005
Policies: 9,400*
Funds set aside: $15.4 million**
Amount insured: $2.6 billion*
Risk factors: This Florida-only home insurer is part of the St. Petersburg-based American Strategic group and does not exhibit any of the risk factors reviewed by the Herald-Tribune. It has $1 in capital for every $168 insured.
About the company: Through a series of other companies it is ultimately owned by Bermuda reinsurance giant XL Re and New York venture capitalist Marc Fasteau. The insurance operation pays affiliated companies to manage day-to-day operations.

AMERICAN STRATEGIC INSURANCE
Started: 1997
Policies: 92,000*
Funds set aside: $140 million**
Amount insured: $39 billion*
Risk factors: This St. Petersburg-based subsidiary of ASI does not exhibit any of the risk factors reviewed by the Herald-Tribune. In comparison, the company keeps $1 in cash reserves for every $279 insured.
About the company: The corporate group ultimately is owned by Bermuda reinsurance giant XL Re and New York venture capitalist Marc Fasteau. Other holdings include Omega, ASI Preferred and ACA Home.

CASTLE KEY and CASTLE KEY INDEMNITY
(formerly Allstate Floridian)
Started: 1997
Policies: 225,000*
Funds set aside: $178 million**
Amount insured: $46 billion*
Risk factors: Formed by Allstate following Hurricane Andrew, Allstate's two Florida-only subsidiaries do not exhibit any of the risk factors reviewed by the Herald-Tribune. The companies have $1 banked for every $259 insured.
About the company: Allstate's two Florida subsidiaries, recently renamed Castle Key and Castle Key Indemnity, have dramatically reduced policies in Florida and are under order from the state to write 100,000 more policies by 2011.

FLORIDA FARM BUREAU CASUALTY
Started: 1974
Policies: 54,000*
Funds set aside: $198 million**
Amount insured: $21 billion*
Risk factors: This company does not exhibit any of the risk factors reviewed by the Herald-Tribune. It has $1 set aside for every $107 insured.
About the company: Gainesville-based Florida Farm Bureau Casualty is a member of the Southern Farm Bureau family. It is considered one of the most stable and well-capitalized Florida-only insurance companies.

NATIONWIDE INSURANCE COMPANY OF FLORIDA
Started: 1998
Policies: 120,600*
Funds set aside: $273 million**
Amount insured: $43 billion*
Risk factors: This Florida-only subsidiary of Nationwide Mutual does not exhibit any of the risk factors reviewed by the Herald-Tribune. It has $1 banked for every $162 insured.
About the company: The company is in the midst of reducing its Florida operations by 60,000 policies and is not writing new policies. Nationwide has been increasing its surplus in Florida, requiring less reinsurance coverage.

SAFEWAY PROPERTY INSURANCE
Started: 1987
Policies: 31,800*
Funds set aside: $19.6 million**
Amount insured: $3 billion*
Risk factors: This Florida-only subsidiary of the Illinois-based Safeway Insurance Co. does not exhibit any of the risk factors reviewed by the Herald-Tribune. The company has $1 banked for every $162 insured.
About the company: Safeway insures houses and mobile homes and is owned and managed by brothers Robert and William Parrillo, investors in the Chicago Sun-Times and sons of an attorney for Al Capone. Another Parrillo brother, Richard, owns two other Florida insurance carriers, Argus Fire and United Auto.

* Figures as of June 30, 2009
** Figures as of September 30, 2009

HERALD-TRIBUNE INVESTIGATION

WEAK INSURERS PUT MILLIONS OF FLORIDIANS AT RISK

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

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

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.

Shaky property insurers put millions of Floridians at risk

BELOW: Albert Fernandez, left, and Alexander Anthony, founders of Northern Capital Insurance, were featured in the September 2009 issue of Inc. Magazine. At that time, the insurer was named fastest-growing private company in the U.S.

LEFT: Anthony, left, and Fernandez, in a photograph taken by Inc. Magazine.

PHOTO PROVIDED BY JEFFERY SALTER / REDUX

INSURANCE *from 1A*

put state residents farther out on a limb.

■ Larger dangers loom. Despite rising property values, one in three Florida carriers has decreased the cash set aside for storms.

The Florida-only carriers that provide the majority of hurricane coverage in this state now stretch their limited cash nearly twice as far as they did before 2004. They do it by buying a form of backstop insurance, called reinsurance, that is supposed to kick in and prevent insurers from failing when major catastrophes strike.

But insurers still must have their own money to pay what amounts to a deductible. And after every storm they need cash to operate and pay claims until they can collect on their backstop policies.

Experts point out that even companies with the best reinsurance policies can fail if they experience cash-flow problems.

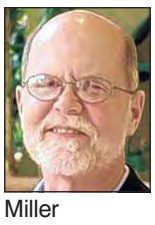
In simplest terms, the average Floridian with a $350,000 house is insured by a company with less than $750 in hand to pay for that home. By contrast, the average carrier had $1,300 in 2003.

That same year, Allstate and other well-funded insurers had nearly $4,000 banked for the same risk.

"It is the Florida Ponzi Scheme," said Miami agent Phil Lyons, secretary of the Independent Insurance Agents of South Florida.

Regulators, insurance executives and industry lobbyists argue that the system, perhaps flawed, is all that Florida has to fill the yawning hole left by the mass exodus of national insurers.

"What were the options?" asked Sam Miller, vice president of the Florida Insurance Council, the industry's largest trade group in the state. "I don't think any other plan would have worked."


Miller

Yet among insurance insiders there is unease and growing alarm.

"There should be bells and whistles going off everywhere," said Jeff Grady, president of the Florida Association of Insurance Agents, where chasing down rumors of failing insurers has become the trade group's recent obsession.

"On the surface it may appear things are OK, but below the surface, things are really troubling."

WHY UPSTART INSURERS DOMINATE IN FLORIDA

Beginning with Hurricane Andrew in 1992 and accelerating after Katrina in 2005, Florida's property insurance market changed dramatically.

State Farm and Allstate, combined protectors of one-third of Florida homeowners before 2004, led a wave of withdrawals, followed by Nationwide, USAA, Hartford and Travelers.

In their place arose what insurance expert Robert Klein, director of the Center for Risk Management and Insurance Research at Georgia State University, calls the "Florida-zation of cat risk."

These are the insurance companies that only do business in Florida, taking an all-or-nothing gamble on the state's weather.

In 1992, these concentrated risk-takers insured just 6 percent of Florida. Today, including the Florida-only subsidiaries of national insurers, they cover 71 percent.

Insurance, historically, has been an industry built on huge reserves. Firms amass a foundation of capital, then risk that money by promising to repay homeowners in the event of losses.

Profits, historically, came from the interest earned on the money that sits waiting to be paid out.

All that has changed. In Florida, insurers are now risk-brokers, players with relatively little money and a lot of leverage. In place of huge cash reserves, they have reinsurance — essentially insurance policies for insurance companies — that pays off in a major disaster. Those policies are so costly that most companies have little money left to build reserves.


Klein

Reinsurance enables fast growth. Instead of building up a company slowly by amassing enough 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 just as quickly, putting thousands of Florida homeowners at risk.

Even in 2000, before the explosion of single-state carriers in Florida, 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 "thinly capitalized, opportunistic insurers."

NOT ENOUGH MONEY TO PAY OFF HOUSE FIRES

Miami businessmen Alexander Anthony and Albert Fernandez sold their security guard business to launch Northern Capital Insurance Group.

They rocketed from $476,000 in revenue in 2006 to more than $95 million by 2008, adding a second carrier, Northern Capital Select, in the process.

Last September, Inc. Magazine heralded the company as "America's Fastest Growing Private Company."

The award came with publicity and a congratulatory letter from Gov. Charlie Crist, thanking the carrier for its phenomenal growth.

But the meteoric rise also came at great risk, mostly to customers.

State records show the group has the most concentrated roll of the dice in all of Florida.

Three of every four policies written by the companies were in a 143-mile stretch of the Atlantic coast — Miami to Palm Beach — that presents the single greatest hurricane threat in all of America. For as far back as the records go, a Category One storm has rolled ashore here at least every four years.

The exposure of these two insurers during the 2009 hurricane season was twice that even of Citizens Property Insurance, the state-run company that covers homes deemed too risky by other insurers. Six other Florida carriers are in the same boat, carrying greater concentrations of risk in Miami than Citizens does.

"It scares me. I fear when the next storm comes. I fear if it lands anywhere near here," said Dulce Suarez-Resnick, a Miami agent who is past president of the Latin American Association of Insurance Agencies.

While Northern Capital Select had the highest concentration of hurricane 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 had greater assets, but also more risk, leaving it at the start of 2009 just above what state laws required for its exposure.

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

They did it with less than $20 million.

The companies bridged the gap by buying huge amounts of reinsurance from overseas investors willing to gamble against a storm. According to third-quarter financial statements, the carriers by September 2009 spent $64 million of the $94 million in premium they collected buying that protection.

Between what the insurers paid for reinsurance and what they paid in other overhead costs, contracts filed with regulators show, there was not enough money left to pay claims.

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

But regulators did not warn consumers about the risk.

Instead, the agency in August secretly prepared an order placing the company under administrative supervision.

While Northern Capital basked in the glow of its Inc. Magazine publicity and hit the financial markets hoping to raise $12 million, OIR sought to require the company to buy more reinsurance and stop writing new business in Miami-Dade, Broward and Palm Beach counties.

An unsigned copy of the confidential order was obtained by the Herald-Tribune. OIR officials refused to acknowledge its existence, and calls to Northern Capital's owners were not returned. President Wayne Fletcher and vice president Will Brauer did not respond to repeated calls.

By October, Northern Capital began retrenching, merging its two insurers into one. In February, the company lost its "A-exceptional" financial rating from Demotech, after the rating agency claimed deadlines to raise additional cash and come up with a new business plan passed unmet.

The company remains in business.

IN THE RED ZONE: 42 INSURERS AND RISK

The financial troubles of Florida insurers go far beyond Northern 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 disclosure, the Herald-Tribune turned to measures commonly used by those in the industry, from agents who place your policy to regulators who police the business, to academics and consumer advocates.

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

They agreed, however, that there are several important indicators of financial weakness and they provided benchmarks for each. They include: low levels of savings, comparatively high amounts of risk, an over-reliance on reinsurance and a heavy concentration of customers in one geographic area.

The Herald-Tribune found that about 30 companies out of more than 70 reviewed appear fiscally sound. Forty-two failed at least one of the benchmarks.

That means one in three privately insured homes in Florida — some 2 million families — relies upon an at-risk insurer for hurricane protection.

Fourteen of those insurers tripped two or more of the four warning flags. Of the three companies 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 insurance brokers, questioned if the Florida insurance market is, in its words, "at the tipping point."

In a report to its insurance company clients, the brokerage estimated that one in 10 Florida carriers has insufficient capital to weather a catastrophe. Not one of the 150 national property insurers reviewed by Aon had the same risk.

Bryon Ehrhart, CEO of Aon Analytics in Chicago, said, "Florida is operating at a much higher leverage rate than the rest of the nation."

See **INSURANCE** *on 12A*

This Key Biscayne house at 260 Glenridge Road was used by Henry James Irl to launch Magnolia Insurance. Insurance agents say the company was run by Irl from his home while it insured billions of dollars in property.

STAFF PHOTO / SELINA ROMAN

Shaky insurers put millions in Florida at risk

INSURANCE *from 11A*

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 Florida 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 FIGA Operations Manager Tom Streuckens.

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 victims 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 claim estimate from the state fund. One is unable to rebuild. Her unlivable, damaged town house sits unrepaired 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 callous indifference."

Even if the program worked perfectly as a backstop, 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 insolvencies. The result would be homeowners receiving only partial payment, then waiting months, if not years, for the rest.

Streuckens 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 borderline amounts of capital — placing $143 billion worth of homes at risk of being uncovered in a catastrophe.

That is one and a half times the size of the insurance companies that failed following the 2004-05 hurricanes.

BILLIONS 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 loan, 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 from Citizens Property Insurance.

By mid-2008, thousands of South 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 office. They didn't even have a Web site. They didn't have a phone." said Dulce Suarez-Resnick, 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-Resnick 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 supervision and ordered its president to leave.

The December order capped what is possibly the shortest start-to-suspension of a Florida insurance 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 the four-bedroom red-tile roof home of company president Henry James Irl.

Florida law allows state regulators to deny an insurance license to a company whose executives show poor financial credibility. Yet the Office of Insurance Regulation cleared Irl, despite the fact that Miami-Dade County Circuit Court files show he had a history of bad credit card debt.

Court filings from 2006 through 2008 show Irl was sued for $40,000 in unpaid debts and interest, resulting in two orders attempting to collect the money by garnishing his wages at the not-yet operational Magnolia.

The last of those cases was not dismissed until the end of 2008. By then, Irl was running an insurance company responsible for the financial security of 100,000 homeowners with property worth $24 billion.

"How did the state of Florida allow this person to get approved to run an insurance company in the state?" asked Suarez-Resnick.

Suarez-Resnick

Officials with Florida's Office of Insurance Information refused to answer questions about Magnolia, including whether Irl had disclosed his personal financial problems. Irl did not respond to messages left with his company or at his home.

Circumstances surrounding Magnolia's supervision remain sealed under Florida insurance laws that treat regulatory investigations 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 operated through the 2009 hurricane season with no outward sign of trouble.

The only specific information about why Magnolia's operations were seized comes through Demotech, the financial rating firm that suspended Magnolia's "A Exceptional" rating two weeks before regulators stepped in.

With the rating suspension, Demotech explained for the first time that it had been negotiating with Magnolia for months over serious problems with its financing, policy handling and management.

FLORIDA OFFICIALS ASK: WHAT CHOICE IS THERE?

The Office of Insurance Regulation readily acknowledges Florida is in the throes of dramatic change.

From Kevin McCarty, insurance commissioner, to the lowest-level regulators, OIR officials expressed optimism for the market as a whole despite trepidation over the stability of individual insurers.

"You're right. There will be failures," said Robin Westcott, solvency director for OIR's property division. However, she and other regulators said, they believe most of Florida's relatively new insurers will survive and a large portion of the market is strong.

These officials argue the failures are a natural byproduct of the state's need to find new insurers quickly as national carriers dumped hundreds of thousands of customers after 2005.

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

The state has, since 2006, attracted 29 new companies with $509 million in new investment.

"I think it's a success story that we're able to attract new companies that are writing 615,000 policies," McCarty told Florida Cabinet members in August.

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

"It is a difficult marketplace. . . . You're getting to a point where these companies are going to separate themselves as to who can do it successfully and then those that aren't going to," Westcott said in November, following the shutdown of American Keystone.

"All we hear from the Legislature is 'Free Market, Free Market, Free Market,'" Westcott said. "Well, this is a function of Free Market."

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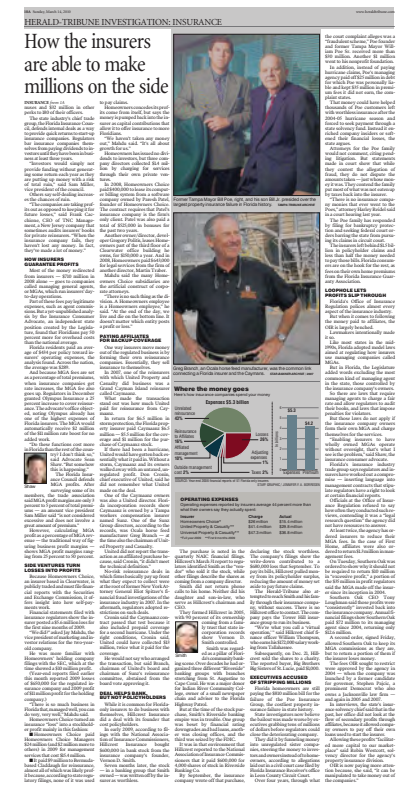
HOW INSURERS MAKE
MILLIONS ON THE SIDE

Pivotal legislative session for topic of open access



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How the insurers are able to make millions on the side

Where the money goes
Expenses $1.3 billion

OPERATING EXPENSES

Home & Site Packages From $500,000 To $3 Million
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HERALD-TRIBUNE INVESTIGATION

HOW INSURERS MAKE MILLIONS ON THE SIDE

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 $1.9 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.

Paresh Patel, chairman of Homeowners Choice Inc., rings the Nasdaq opening bell on Aug. 4, 2008.

PHOTO PROVIDED BY NASDAQ

■ 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 bo-

See **INSURANCE** *on 10A*

FLORIDA'S INSURANCE NIGHTMARE

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ONLINE: Part 1, including financial measures for more than 50 insurers, at heraldtribune.com/floridainsurance.

COMING SOON: Florida regulators cut corners and look the other way even as they acknowledge the danger.

How the insurers are able to make millions on the side

INSURANCE *from 1A*

nuses and $32 million in other perks to 180 of their officers.

The state industry's chief trade group, the Florida Insurance Council, defends internal deals as a way to provide quick returns to start-up insurance companies. Regulators bar insurance companies themselves from paying dividends to investors until they have been in business at least three years.

"Investors would simply not provide funding without generating some return each year as they are putting up money with a risk of total ruin," said Sam Miller, vice president of the council.

Others say self-dealing increases the chances of ruin.

"The companies are taking profits out as opposed to keeping it for future losses," said Frank Cacchione, CEO of TNC Management, a New Jersey company that sometimes audits insurers' books for private reinsurers. "When the insurance company fails, they haven't lost any money. In fact, they've made a lot of money."

HOW INSURERS GUARANTEE PROFITS

Most of the money redirected from insurers — $710 million in 2008 alone — goes to companies called managing general agents, or MGAs, which run insurers' day-to-day operations.

Part of these fees pay legitimate expenses, such as agent commissions. But a yet-unpublished analysis by the Insurance Consumer Advocate, an independent state position created by the Legislature, found that Floridians pay 50 percent more for overhead costs than the national average.

Florida residents paid an average of $434 per policy toward insurers' operating expenses, the analysis found. Across the nation, the average was $289.

And because MGA fees are set as a percentage of total premiums, when insurance companies get rate increases, the MGA fee also goes up. Regulators in December granted Olympus Insurance a 25 percent increase to cover reinsurance. The advocate's office objected, noting Olympus already has one of the highest expenses of Florida insurers. The MGA would automatically receive $2 million of the $11 million rate boost for no added work.

"Do these functions cost more in Florida than the rest of the country? I don't think so," said Advocate Sean Shaw. "But somehow this is happening."


Shaw

The Florida Insurance Council defends MGA profits. After surveying some of its members, the trade association said MGA profit margins are only 3 percent to 5 percent of total premiums — an amount vice president Sam Miller said "is not considered excessive and does not involve a great amount of premium."

However, calculating MGA profit as a percentage of MGA revenue — the traditional way of figuring business profit margins — shows MGA profit margins ranging from 25 percent to 50 percent.

SIDE VENTURES TURN LOSSES INTO PROFITS

Because Homeowners Choice, an insurer based in Clearwater, is publicly traded and must file financial reports with the Securities and Exchange Commission, it offers insight into how self-payments work.

Financial statements filed with insurance regulators show the insurer posted a $5.6 million loss for the first nine months of 2009.

"We did?" asked Jay Mahdu, the vice president of marketing and investor relations for the two-year-old company.

He was more familiar with Homeowners' holding company filings with the SEC, which at the time showed a $10 million profit.

(Year-end reports filed earlier this month reported 2009 losses of $650,000 for the regulated insurance company and 2009 profit of $11 million profit for the holding company.)

"There is so much business in Florida that, managed well, you can do very, very well," Mahdu said.

Homeowners Choice turned an insurance "loss" into a stockholder profit mainly in this fashion:

- Homeowners Choice paid Homeowners Choice Managers $24 million (and $2 million more to others) in 2009 for management services that cost $15.4 million.
- It paid $9 million to Bermuda-based Claddaugh for reinsurance, almost all of which was likely profit because, according to state regulatory filings, none of it was used to pay claims.

Homeowners concedes its profits come from itself, but says the money is pumped back into the insurer as capital contributions that allow it to offer insurance to more Floridians.

"We haven't taken any money out," Mahdu said. "It's all about growth for us."

Homeowners has issued no dividends to investors, but three company directors collected $1.4 million by charging for services through their own private ventures.

In 2008, Homeowners Choice paid $400,000 to lease its computer billing system from a software company owned by Paresh Patel, founder of Homeowners Choice. The contract requires that Patel's insurance company is the firm's only client. Patel was also paid a total of $525,000 in bonuses for the past two years.

Another owner/director, developer Gregory Politis, leases Homeowners part of the third floor of a Clearwater office building he owns, for $150,000 a year. And in 2008, Homeowners paid $643,000 for legal services from the firm of another director, Martin Traber.

Mahdu said the many Homeowners Choice subsidiaries are the artificial construct of corporate attorneys.

"There is no such thing as the division. A Homeowners employee is a Homeowners employee," he said. "At the end of the day, we live and die on the bottom line. It doesn't matter which entity posts a profit or loss."

PAYING AFFILIATES FOR BACKUP COVERAGE

One way insurers move money out of the regulated business is by forming their own reinsurance companies. Essentially, they sell insurance to themselves.

In 2007, one of the reinsurers with which United Property and Casualty did business was a Grand Cayman Island reinsurer called Caymaanz.

What made the transaction stand out was how much United paid for reinsurance from Caymaanz.

In return for $6.5 million in storm protection, the Florida property insurer paid Caymaanz $6.5 million — $5.5 million for the coverage and $1 million for the purchase of Caymaanz stock.

If there had been a hurricane, United would have gotten back essentially what it paid in. Without a storm, Caymaanz and its owners walked away with an untaxed, unregulated profit. Don Cronin, chief executive of United, said he did not remember what United made on the deal.

One of the Caymaanz owners was also a United director. Florida incorporation records show Caymaanz is owned by a Tampa workers compensation insurer named Sunz. One of the Sunz Group directors, according to the records, was Ocala horse feed manufacturer Greg Branch — at the time also the chairman of United Property and Casualty.

United did not report the transaction as an affiliated purchase because, said Cronin, "it didn't meet the technical definition."

No-risk reinsurance deals in which firms basically pay up front what they expect to collect were at the root of former New York Attorney General Eliot Spitzer's financial fraud investigations of the insurance industry in 2007. In the aftermath, regulators adopted restrictions on such deals.

Cronin said the Caymaanz contract passed that test because it also included prepaid coverage for a second hurricane. Under the right conditions, Cronin said, United could have collected $13 million, twice what it paid for the coverage.

He would not say who arranged the transaction, but said Branch, chairman of United's board and chairman of Sunz's reinsurance committee, abstained from the board vote approving it.

DEAL HELPS BANK, BUT NOT POLICYHOLDERS

While it is common for Florida-only insurers to do business with themselves, Hillcrest Insurance did a deal with its founder that cost policyholders.

In early 2009, according to filings with the National Association of Insurance Commissioners, Hillcrest Insurance bought $600,000 in bank stock from the insurance company's founder, Vernon D. Smith.

Seven months later, the stock — in a banking group that Smith owned — was written off by the insurer as worthless.

The purchase is noted in the quarterly NAIC financial filings. Hillcrest's March 31 report to regulators identified Smith as the "vendor" who sold it the stock, while other filings describe the shares as coming from a company director.

Smith did not return phone calls to his home. Neither did his daughter and son-in-law, who serve as Hillcrest's chairman and CEO.

They formed Hillcrest in 2005, with 90 percent of its ownership coming from a family trust that state incorporation records show Vernon D. Smith controlled.


Smith

Smith was regarded as a pillar of Florida's community banking scene. Over decades he had organized three different "Riverside" banking groups with branches stretching from St. Augustine to Cape Coral. He was a major donor for Indian River Community College, owner of a small newspaper chain and adviser to the Florida Highway Patrol.

But at the time of the stock purchase, Smith's Riverside banking empire was in trouble. One group was beset by financial rating downgrades and bad loans, another was closing offices, and the third was seized by the FDIC.

It was in that environment that Hillcrest reported to the National Association of Insurance Commissioners that it paid $600,000 for 4,000 shares of stock in Riverside Banking Co.

By September, the insurance company wrote off that purchase, declaring the stock worthless. The company's filings show the write-down contributed to a $680,000 loss that September. To pay its bills, Hillcrest pulled money from its policyholder surplus, reducing the amount of money set aside to pay future claims.

The Herald-Tribune also attempted to reach Smith and his family through their insurance company, without success. There is no Hillcrest office to contact. The company pays the Tower Hill insurance group to run its business.

"We're what you call a 'virtual operation,' " said Hillcrest chief finance officer William Thompson, who earns his $172,000 salary working from Tallahassee.

Subsequently, on Dec. 21, Hillcrest sold the shares to a charity. The reported buyer, Big Brothers Big Sisters of St. Lucie, paid $1,000.

EXECUTIVES ACCUSED OF STRIPPING MILLIONS

Florida homeowners are still paying the $810 million bill for the failure of the Poe Insurance Group, the costliest property insurance failure in state history.

State investigators now believe the bailout was made worse by executives grabbing tens of millions of dollars before regulators could close the deteriorating company.

They did it by funneling money into unregulated sister companies, steering the money to investors and owners instead of to homeowners, according to allegations laid out in a civil court case filed by Florida Insurance Receiver's office in Leon County Circuit Court.

Over four years, through what the court complaint alleges was a "fraudulent scheme," Poe founder and former Tampa Mayor William Poe Sr. received more than $30 million. Another $1 million went to his nonprofit foundation.

In addition, instead of paying hurricane claims, Poe's managing agency paid off $25 million in debt for which Poe was personally liable and kept $35 million in premium fees it did not earn, the complaint states.

That money could have helped thousands of Poe customers left with worthless insurance after the 2004-05 hurricane season and forced to seek payment through a state solvency fund. Instead it enriched company insiders or softened their financial losses, the state argues.

Attorneys for the Poe family would not comment, citing pending litigation. But statements made in court show that while they contest the allegation of fraud, they do not dispute the amounts taken — just whose money it was. They contend the family put most of what was not eaten up by taxes back into the insurer.

"There is no insurance company monies that ever went to the Poes," attorney Harley Reidel said in a court hearing last year.

The Poe family has responded by filing for bankruptcy protection and seeking federal court orders barring the state from pursuing its claims in circuit court.

The insurers left behind $1.5 billion in policyholder claims and less than half the money needed to pay those bills. Florida consumers are on the hook for the rest, as fees on their own home premiums from the Florida Insurance Guaranty Association.

LOOPHOLE LETS PROFITS SLIP THROUGH

Florida's Office of Insurance Regulation polices almost every aspect of the insurance industry.

But when it comes to following the money paid to affiliates, the OIR is largely benched.

Lawmakers intentionally made it so.

Like most states in the mid-1990s, Florida adopted model laws aimed at regulating how insurers use managing companies called MGAs.

But in Florida, the Legislature added words excluding the most common kind of managing agent in the state, those controlled by the insurance company's owners.

So there are laws that require managing agents to charge a fair rate and allow regulators to audit their books, and laws that impose penalties for violators.

But those laws do not apply if the insurance company owners form their own MGA and charge themselves for the services.

"Enabling insurers to have wholly owned MGAs operate without oversight, that's what I see is the problem," said Shaw, the insurance consumer advocate.

Florida's insurance industry trade group says regulators and insurers have worked out a compromise — inserting language into management contracts that stipulate regulators have a right to look at certain financial reports.

Officials at the Office of Insurance Regulation refused to say how often they conducted such reviews, contending it was a "legal research question" the agency did not have resources to answer.

At least twice, the agency has ordered insurers to reduce their MGA fees. In the case of First Home, affiliates were also ordered to return $1.3 million in management fees.

On Tuesday, Southern Oak was ordered to show why it should not be required to return $10 million in "excessive profit," a portion of the $35 million in profit regulators said the MGA made off the insurer since its inception in 2004.

Southern Oak CEO Tony Loughman said those profits were "consistently" invested back into the insurance company. Annual financial filings show Southern Oak paid $72 million to its managing agent since 2004, returning only $12.6 million.

A second order, signed Friday, allowed Southern Oak to keep its MGA commissions as they are, but to return a portion of them if the insurer loses money.

The fees OIR sought to restrict were approved by the agency in 2004 — when the company was launched by a former candidate for governor, Stephen Pajcic, a prominent Democrat who also owns a Jacksonville law firm — and again in 2005 and 2007.

In interviews, the state's insurance solvency chief said that in the past, her office did not look at the flow of secondary profits through affiliates, because it allowed company owners to pay off their own loans used to start the insurer.

Allowing these profits "facilitated more capital to our marketplace" said Robin Westcott, solvency director for the agency's property insurance division.

OIR is now paying more attention because, she said, "it can be manipulated to take money out of the companies."

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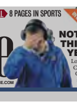


NOT THIS YEAR
Loss to South Carolina dashes Gators' hopes for shot at title. **1C**

Global twist to war on smokes

TOBACCO: Industry giants fight marketing limits in the developing world

By DUFF WILSON
The New York Times

As sales to developing nations become ever more important to giant tobacco companies, they are stepping up efforts to fight tough restrictions on the marketing of cigarettes.

Companies like Philip Morris International and British American Tobacco are contesting limits on advertising in Britain, bigger health warnings in South America and higher cigarette taxes in the Philippines and Mexico. They are also spending billions on lobbying and promotional campaigns in Africa, and in one case providing undisclosed financing for TV commercials in Australia.

The industry has ramped up its efforts in advance of a gathering in Uruguay this week of public health officials from 171 nations, who plan to shape guidelines to enforce a global anti-smoking treaty.

Earlier this year, Philip Morris International sued the government of Uruguay, saying its tobacco regulations were excessive. World Health Organization officials say the suit represents an effort by the industry to intimidate the country, as well as other nations attending the conference, that are considering strict marketing requirements for tobacco.

Uruguay's groundbreaking

See **CIGARETTES** *on 17A*

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 Fairmont Princess in Bermuda, where RMS asked hurricane scientists to give it a glimpse into the future. STAFF PHOTO / PAIGE ST. JOHN

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 flouted 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.

INSIDE

LOCAL
STAGED FIGHT, REAL HITS
Sarasota couple take the blood and bruises that come with roles at the medieval fair. **1B**

REAL ESTATE
PRIVACY RULES AT INN
The rich and famous can play in peace at The Gasparilla Inn, which is almost 100 years old. **1I**

ARTS*
BONNIE LOVES CLYDE
Asolo's musical takes a new look at the criminal couple. **1E**

HERALDTRIBUNE.COM/SPOTTED
HAVE YOU BEEN SPOTTED?
Check out online galleries from community events throughout the area.

SNN LOCAL NEWS 6
SOME HELP FROM ABOVE
The Civil Air Patrol is flying low and slow to assist emergency operations in Sarasota.

Arts	1E	Obituaries	10B
Classified	1F	Opinion	22A
Lottery	2A	People	11B
Movie Log	11B	Sports	1C

OUR 86TH YEAR NUMBER 42

ARTS*
COMING HOME
Local fans of Sarasota singer Syesha Mercado can see her perform in "Dreamgirls" this week in Tampa. **1E**

For Housing Authority, a new sort of housing

FEDERAL FUNDS: Rehabbing and renting out houses that might otherwise lie fallow

By DALE WHITE
dale.white@heraldtribune.com

SARASOTA — Tanya Dupont had been living with relatives when she got an opportunity last month to move into a completely renovated rental home.

"It was worth the wait," said Dupont, who teaches children at the Sarasota Family YMCA and attends classes to earn a degree in early childhood education.

The three-bedroom, two-and-a-half-bath house is a perfect fit for herself, her 18-year-old son and her year-old daughter.

The house, which had been in foreclosure, has been renovated top to bottom, with energy-efficient appliances and storm-resistant windows.

"It's new everything. They have been really good to me," Dupont said of her landlord, the Sarasota Housing Authority.

Owning rental property is nothing new for the Housing Authority, which for decades has provided subsidized apartments for low-income residents.

Now the Housing Authority is treading new ground by buying and renovating homes, then renting them to low-income families. The program is funded by a $24 million line of credit from the federal government that is intended to assist various affordable housing providers in acquiring and rehabilitating foreclosed and abandoned homes.

The goal of the federal Neighborhood Stabilization Program is twofold: Help lower-income families find decent housing, and protect neighborhoods from blight and plummeting property values.

The program is not without its critics, who regard it as more stimulus pork and another bailout for banks that made bad loans.

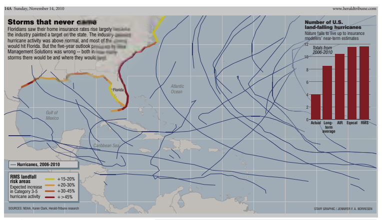
They claim local housing officials might use it to favor certain lenders and nonprofit builders;

See **RENTALS** *on 17A*

Housing Authority Executive Director Bill Russell, in a distressed home. With the aid of a federal program, the agency can get homes renovated and rented to lower-income tenants. STAFF PHOTO / DALE WHITE

Storms that never came

Floridians saw their home insurance rates rise largely [illegible] the industry painted a target on the state. The industry [illegible] hurricane activity was above normal, and most of the [illegible] would hit Florida. But the five-year outlook [illegible] Management Solutions was wrong -- both in [illegible] storms there would be and where they would [illegible]



SOURCES: NOAA, Karen Clark, Herald-Tribune research

STAFF GRAPHIC / JENNIFER F. A. BORRESEN

The creation of an $82 billion hurricane threat

MEET THE SCIENTISTS

California risk modeler RMS picked four climate scientists to determine how much to increase hurricane rates.

Jim Elsner
Florida State University
An expert in using statistical models to show impacts of climate change on tropical cyclone activity. Funded in part from the industry's Bermuda-based Risk Prediction Initiative. Elsner has developed annual hurricane activity models for investors. He was a consultant to model developers, including RMS and AIR Worldwide, but questions the approach used by RMS.

Mark Saunders
University College London
A British climate physicist focused on using statistical models to produce short-term hurricane forecasts and their use by insurers to increase profits. He also reports a connection between sea surface temperature and hurricane frequency in the Atlantic. Saunders runs the industry-funded Tropical Storm Risk in London.

Kerry Emanuel
Massachusetts Institute of Technology
An expert in the use of climate models to simulate tropical cyclones and global warming. His 2005 paper in "Nature" linked a half-degree rise in ocean temperature to increased destructive potential of hurricanes. He participated in a later RMS panel and helped RMS identify other scientists, and has consulted for competitor AIR Worldwide. Emanuel now doubts the accuracy of short-term predictions.

Tom Knutson
National Oceanic and Atmospheric Administration
Federal research meteorologist and co-chair of a global scientific team to provide advice on tropical cyclones and climate change. Knutson's modeling work simulates the impact of rises in greenhouse gases. He participated in a second RMS panel, and has been a frequent speaker to reinsurance companies seeking his expertise.

MODELS *from 1A*

computer model illegal.

Florida homeowners would have paid more even without RMS' new model. Katrina convinced the industry that hurricanes were getting bigger and more frequent. But it was RMS that first put a number to the increased danger and came up with a model to justify it.

As a result of RMS' changes, the cost to insure a home in parts of Florida hit world-record levels.

Hundreds of thousands of homeowners were forced to find new insurers as national carriers fled the state.

Yet the prediction of a more dangerous Florida has not played out.

The new RMS model called for at least 11 hurricanes to come ashore in the United States by the end of 2010, most of them aimed at Florida.

Four hurricanes struck the U.S. None hit the Sunshine State.

RMS stands by its five-year outlook and contends that the risk of hurricanes remains higher than normal. Company officials last week said they would continue to adjust their model as needed, but a single five-year lull does not disprove their results.

Yet a growing number of experts now wonder if the changes spurred by RMS — and the accompanying spike in insurance premiums — were justified.

The woman credited with launching the industry of hurricane modeling questions how near-term models were introduced. She accuses RMS of overselling software that lacked sufficient scientific support, and says insurers accepted the output of that model as if it were fact.

"I've never seen the industry so much just hanging on what a handful of scientists or one model would say," said Karen Clark, founder and former CEO of AIR Worldwide, an RMS competitor.

"They're just tools," Clark said.

"They're models.

"They're wrong."

FOUR MEN, FOUR HOURS

The daily papers were still blaring news about Katrina when Jim Elsner received an invitation to stay over a day in Bermuda.

The hurricane expert from Florida State University would be on the island in October for an insurance-sponsored conference on climate change. One of the sponsors, a California-based company called RMS, wanted a private discussion with him and three other attendees.

Their task: Reach consensus on how global weather patterns had changed hurricane activity.

The experts pulled aside by RMS were far from representative of the divided field of tropical cyclone science. They belonged to a camp that believed hurricane activity was on the rise and, key to RMS, shared the contested belief that computer models could accurately predict the change.

Elsner's statistical work on hurricanes and climatology included a model to predict hurricane activity six months in advance, a tool for selling catastrophe bonds and other products to investors.

There was also Tom Knutson, the National Oceanic and Atmospheric Administration meteorologist whose research linking rising carbon dioxide levels to potential storm damage had led to censoring by the Bush White House.

Joining them was British climate physicist Mark Saunders, who argued that insurers could use model predictions from his insurance-industry-funded center to increase profits 30 percent.

The rock star in the room was Kerry Emanuel, the oracle of climate change from the Massachusetts Institute of Technology. Just two weeks before Katrina, one of the world's leading scientific journals had published Emanuel's concise but frightening paper claiming humanity had changed the weather and doubled the damage potential of cyclones worldwide.

Elsner said he anticipated a general and scholarly talk.

Instead, RMS asked four questions: How many more hurricanes would form from 2006 to 2010? How many would reach land? How many the Caribbean? And how long would the trend last?

Elsner's discomfort grew as he realized RMS sought numbers to hard-wire into the computer program that helps insurers set rates.

"We're not really in the business of making outlooks. We're in the business of science," he told the Herald-Tribune in a 2009 interview. "Once I realized what they were using it for, then I said, 'Wait a minute.' It's one thing to talk about these things. It's another to quantify it."

Saunders did not respond to questions from the Herald-Tribune. Knutson said if RMS were to ask again, he would provide the same hurricane assessment he gave in 2005.

But Emanuel said he entered the discussion in 2005 "a little mystified" by what RMS was doing.

He now questions the credibility of any five-year prediction of major hurricanes. There is simply too much involved.

"Had I known then what I know now," Emanuel said, "I would have been even more skeptical."

Elsner's own frustration grew when he attempted to interject a fifth question he thought critical to any discussion of short-term activity: Where would the storms go?

The RMS modelers believed Florida would remain the target of most hurricane activity. Elsner's research showed storm activity shifted through time and that it was due to move north toward the Carolinas.

But RMS' facilitator said there was not enough time to debate the matter, Elsner said. There were planes to catch.

In the end, the four scientists came up with four hurricane estimates — similar only in that they were all above the historic average.

RMS erased that difference with a bit of fifth-grade math. It calculated the average.

Thus, the long-term reality of 0.63 major hurricanes striking the U.S. every year yielded to a prediction of 0.90.

Contrary to Elsner's research, RMS aimed most of that virtual increase at Florida.

On paper, it was a small change from one tiny number to another tiny number.

Plugged into the core of a complex software program used to estimate hurricane losses, the number rewrote property insurance in North America.

Risk was no longer a measure of what had been, but what might be. And for Floridians living along the Atlantic, disaster was 45 percent more likely.

RMS defended its new model by suggesting it had brought scientists together for a formal, structured debate.

Elsner disputes that idea.

"We were just winging it," he said.

PREDICTING APOCALYPSE

In the Oz of insurance, RMS is the man behind the curtain.

The company is a Silicon Valley prodigy created 22 years ago by four Stanford graduates and their engineering professor, who parlayed a research project into a commodity: calculating earthquake probabilities and selling them to the insurance industry.

It was a short leap from there to run odds on just about every terrible and unlikely event, from Florida hurricanes to Japanese typhoons to European tempests, what RMS CEO and co-founder Hemant Shah calls a "full portfolio of apocalyptic hazard events."

The company Shah started from his California apartment is now a $200 million-a-year enterprise. Major insurance and reinsurance companies the world over pay annual subscriptions of $1 million or more to lease RMS' disaster-predicting software.

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 disband the long-term outlook. Insurance insiders wanted something they believed would be more accurate. And they wanted it to forecast hurricane activity for next few years based on current conditions, not simply assume history would repeat itself.

The pressure came from several places. Some reinsurers sought validation that global warming was increasing the threat of hurricanes. Others in the industry wanted a short-term model to encourage investors, who wanted odds on their returns in the near term.

Shah says he had an obligation to pursue the short-term model because of the belief that hurricanes had gotten more dangerous.

"How are you going to incent people to mitigate their homes if you don't have the right kind of signaling on what risk really is?" he told the Herald-Tribune in 2008.

An accurate prediction of the near future could save insurers 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 researcher Robert Muir-Wood wrote in a February 2006 column, "is likely to be the most eagerly awaited model ever introduced into the reinsurance market."

RUSHING TO RAISE RATES

Records show reinsurers and insurers did not wait.

Using numbers RMS provided in its promotional materials, they began increasing their own hurricane loss estimates 30 to 40 percent, six months before the new model was finished in May 2006.

Florida insurers in turn sought rate boosts in anticipation of what the new model would do to their own costs.

But the 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 is the single largest threat of insolvency to an insurance company," Devin Inskeep, senior financial analyst at A.M. Best, said in an interview.

According to a confidential presentation one of its officers gave an industry think tank, RMS calculated its new hurricane model raised the expected cost of a ma-

See **MODELS** *on 15A*

How insurance bills grew

The worst Florida insurance crisis since Hurricane Andrew began not with the weather, but with a computer model. Here's how:

2005

Aug. 19 Hurricane Katrina strikes New Orleans. Shocked insurance companies lobby for changes in how hurricane risk is predicted.

Oct. 15 Risk Management Solutions assembles four scientists to create a five-year hurricane outlook that nearly doubles the number of expected storms.

Dec. 1 Financial rating firm A.M. Best endorses the still-unseen five-year model, requiring it for solvency tests.

2006

Jan. Insurers use RMS marketing materials to incorporate the higher risk estimates into their own rates.

May RMS releases its five-year model, estimating it and other changes will require the insurance industry to raise $82 billion in capital.

June The surge in demand for reinsurance leads to a tripling of its price in Florida. Insurers pass the bill to homeowners. Premiums jump 85 percent from 2004.

Dec. Insurers cut their risk by fleeing the coast, dumping more than 300,000 Floridians in 2006.

2010

Today Florida homeowners still pay 33 percent more than they did before the model change.

STAFF GRAPHIC / JENNIFER F. A. BORRESEN

More storms now than ever? Yes. No. Maybe.

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

The common insurance industry claim that hurricanes are on the rise lacks an essential ingredient — scientific agreement.

Findings that show a rise in hurricane activity over the Atlantic Ocean have been challenged by new studies. Some scientists say what has actually increased is the ability to spot storms. Others point out that what matters most has not changed at all — the number of storms coming ashore.

There is no single, shared scientific view that hurricanes are more frequent or more dangerous, according to Colorado State University science policy professor Roger Pielke Jr.

"There are instead many scientific justifications pointing in different directions."

Faced with a choice, insurers understandably tend to favor that which leads to the highest rates, and thus the best chance they can cover anything.

That's good for insurers, but not necessarily for their customers.

Insurers have embraced the work of researchers such as Massachusetts Institute of Technology climatologist Kerry Emanuel, who in 2005 concluded that rising ocean temperatures had nearly doubled the destructive potential of hurricanes.

Such findings were the most-cited reason for huge spikes in coastal insurance premiums over the past five years.

But in a recently published scientific paper, even Emanuel concedes some of his original conclusions may have been premature.

All along, there have been scientists with a different view.

To start, there is no increase in hurricane activity where it tends to matter most — on land. And the increase in storms at sea may have more to do with tracking methods than an actual increase in storms.

Older hurricane counts relied on storms being encountered by passing ships. Shipping routes left a huge "hole" in the Atlantic with little traffic, and thus little record of storm activity.

Only since the advent of satellites have scientists been able to see every storm, no matter how remote or short-lived.

Tropical disturbances are now measured hourly, increasing the chance of capturing peak intensity. And what it takes to be declared a storm has been relaxed to include even so-called "mini-whirls" that blow up and die in a day.

Six of the storms in 2007 and 2008 were so weak and short-lived they likely would have remained nameless in past years, said Chris Landsea, science and operations officer at the National Hurricane Center.

Adjusting for these changes, Landsea concludes that Atlantic hurricane activity shows a slight decline.

Other scientists contend that for the past 30 years at least, hurricane activity in the open Atlantic has increased.

The question for them is why there is no noted increase on land.

Some scientists say conditions warming up the Atlantic also promote wind sheer that kills hurricanes.

Others say the year-to-year unpredictability of hurricanes is so great it drowns out any small changes in the average number of storms.

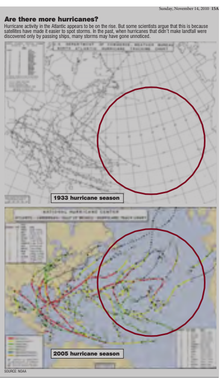
Florida State University researcher Jim Elsner says common sense dictates that a rise in ocean activity will, sooner or later, mean an increase on shore.

"This climate signal is less clear," hedged Tom Knutson, a hurricane researcher at the National Oceanic and Atmospheric Administration.

The odds slightly favor Elsner's point of view, Knutson said, but "there is no certain answer."

Are there more hurricanes?

Hurricane activity in the Atlantic appears to be on the rise. But some scientists argue that this is because satellites have made it easier to spot storms. In the past, when hurricanes that didn't make landfall were discovered only by passing ships, many storms may have gone unnoticed.



SOURCE: NOAA

A price based on a dubious model

The computers at Hemant Shah's RMS contain models of virtually every U.S. disaster in the last 200 years. His company's predictions have helped reshape the industry. LOS ANGELES TIMES / RANDI LYNN BEACH

MODELS *from 14A*

jor 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 $82 billion to remain solvent.

RMS' two chief competitors argued there was inadequate scientific grounding to heavily promote a five-year outlook.

Clark, at the time CEO of AIR Worldwide, said she urged A.M. Best to reconsider requiring a model "based on theories."

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 Eqecat 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 in Florida.

In a calculation Florida regulators learned about two years later, State Farm added a $1.5 billion "frequency adjustment" to its potential hurricane losses. That, in turn, required it to buy more reinsurance from its parent, a cost that resulted in a 47 percent rate increase to its Florida customers.

Allstate increased the loss estimates of its long-term hurricane model by 41 percent, a "climate cycle" adjustment it only briefly noted within its 4,000-page request for a 22 percent rate hike.

By the time the actual model was released in May 2006, it had already reshaped the Florida property insurance market, unleashing the largest spike in premiums in state history.

Florida has a law intended to prevent just such chaos.

A state commission must review and approve catastrophe models 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 were invited.

Shah later told the Herald-Tribune he believed Florida was "mucking things up," suppressing a credible view of risk "so pricing can be more affordable."

"If you artificially constrain your view of risk then you're not going to have the clarity of insight that suggests what really needs to be done to solve the problem," he said.

RMS continues to promote its short-term model as the preferred option for its customers. A survey by Bermuda officials shows it is the dominant model for Bermuda reinsurers, the most crucial source of private hurricane protection for Florida.

MONKEYS COULD DO THIS

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

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Even after it was released, brokers said, the revised model was not roundly embraced.

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"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."

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 Fairmont Princess in Bermuda, where RMS asked hurricane scientists to give it a glimpse into the future. *STAFF PHOTO / PAIGE ST. JOHN*

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 flouted 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

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 1A*

computer model illegal.

Florida homeowners would have paid more even without RMS' new model. Katrina convinced the industry that hurricanes were getting bigger and more frequent. But it was RMS that first put a number to the increased danger and came up with a model to justify it.

As a result of RMS' changes, the cost to insure a home in parts of Florida hit world-record levels.

Hundreds of thousands of homeowners were forced to find new insurers as national carriers fled the state.

Yet the prediction of a more dangerous Florida has not played out.

The new RMS model called for at least 11 hurricanes to come ashore in the United States by the end of 2010, most of them aimed at Florida.

Four hurricanes struck the U.S. None hit the Sunshine State.

RMS stands by its five-year outlook and contends that the risk of hurricanes remains higher than normal. Company officials last week said they would continue to adjust their model as needed, but a single five-year lull does not disprove their results.

Yet a growing number of experts now wonder if the changes spurred by RMS — and the accompanying spike in insurance premiums — were justified.

The woman credited with launching the industry of hurricane modeling questions how near-term models were introduced. She accuses RMS of overselling software that lacked sufficient scientific support, and says insurers accepted the output of that model as if it were fact.

"I've never seen the industry so much just hanging on what a handful of scientists or one model would say," said Karen Clark, founder and former CEO of AIR Worldwide, an RMS competitor.

"They're just tools," Clark said.

"They're models.

"They're wrong."

FOUR MEN, FOUR HOURS

The daily papers were still blaring news about Katrina when Jim Elsner received an invitation to stay over a day in Bermuda.

The hurricane expert from Florida State University would be on the island in October for an insurance-sponsored conference on climate change. One of the sponsors, a California-based company called RMS, wanted a private discussion with him and three other attendees.

Their task: Reach consensus on how global weather patterns had changed hurricane activity.

The experts pulled aside by RMS were far from representative of the divided field of tropical cyclone science. They belonged to a camp that believed hurricane activity was on the rise and, key to RMS, shared the contested belief that computer models could accurately predict the change.

Elsner's statistical work on hurricanes and climatology included a model to predict hurricane activity six months in advance, a tool for selling catastrophe bonds and other products to investors.

There was also Tom Knutson, the National Oceanic and Atmospheric Administration meteorologist whose research linking rising carbon dioxide levels to potential storm damage had led to censoring by the Bush White House.

Joining them was British climate physicist Mark Saunders, who argued that insurers could use model predictions from his insurance-industry-funded center to increase profits 30 percent.

The rock star in the room was Kerry Emanuel, the oracle of climate change from the Massachusetts Institute of Technology. Just two weeks before Katrina, one of the world's leading scientific journals had published Emanuel's concise but frightening paper claiming humanity had changed the weather and doubled the damage potential of cyclones worldwide.

Elsner said he anticipated a general and scholarly talk.

Instead, RMS asked four questions: How many more hurricanes would form from 2006 to 2010? How many would reach land? How many the Caribbean? And how long would the trend last?

Elsner's discomfort grew as he realized RMS sought numbers to hard-wire into the computer program that helps insurers set rates.

"We're not really in the business of making outlooks. We're in the business of science," he told the Herald-Tribune in a 2009 interview. "Once I realized what they were using it for, then I said, 'Wait a minute.' It's one thing to talk about these things. It's another to quantify it."

Saunders did not respond to questions from the Herald-Tribune. Knutson said if RMS were to ask again, he would provide the same hurricane assessment he gave in 2005.

But Emanuel said he entered the discussion in 2005 "a little mystified" by what RMS was doing.

He now questions the credibility of any five-year prediction of major hurricanes. There is simply too much involved.

"Had I known then what I know now," Emanuel said, "I would have been even more skeptical."

Elsner's own frustration grew when he attempted to interject a fifth question he thought critical to any discussion of short-term activity: Where would the storms go?

MEET THE SCIENTISTS

California risk modeler RMS picked four climate scientists to determine how much to increase hurricane rates.

Jim Elsner
Florida State University
An expert in using statistical models to show impacts of climate change on tropical cyclone activity. Funded in part from the industry's Bermuda-based Risk Prediction Initiative. Elsner has developed annual hurricane activity models for investors. He was a consultant to model developers, including RMS and AIR Worldwide, but questions the approach used by RMS.

Mark Saunders
University College London
A British climate physicist focused on using statistical models to produce short-term hurricane forecasts and their use by insurers to increase profits. He also reports a connection between sea surface temperature and hurricane frequency in the Atlantic. Saunders runs the industry-funded Tropical Storm Risk in London.

Kerry Emanuel
Massachusetts Institute of Technology
An expert in the use of climate models to simulate tropical cyclones and global warming. His 2005 paper in "Nature" linked a half-degree rise in ocean temperature to increased destructive potential of hurricanes. He participated in a later RMS panel and helped RMS identify other scientists, and has consulted for competitor AIR Worldwide. Emanuel now doubts the accuracy of short-term predictions.

Tom Knutson
National Oceanic and Atmospheric Administration
Federal research meteorologist and co-chair of a global scientific team to provide advice on tropical cyclones and climate change. Knutson's modeling work simulates the impact of rises in greenhouse gases. He participated in a second RMS panel, and has been a frequent speaker to reinsurance companies seeking his expertise.

The RMS modelers believed Florida would remain the target of most hurricane activity. Elsner's research showed storm activity shifted through time and that it was due to move north toward the Carolinas.

But RMS' facilitator said there was not enough time to debate the matter, Elsner said. There were planes to catch.

In the end, the four scientists came up with four hurricane estimates — similar only in that they were all above the historic average.

RMS erased that difference with a bit of fifth-grade math. It calculated the average.

Thus, the long-term reality of 0.63 major hurricanes striking the U.S. every year yielded to a prediction of 0.90.

Contrary to Elsner's research, RMS aimed most of that virtual increase at Florida.

On paper, it was a small change from one tiny number to another tiny number.

Plugged into the core of a complex software program used to estimate hurricane losses, the number rewrote property insurance in North America.

Risk was no longer a measure of what had been, but what might be. And for Floridians living along the Atlantic, disaster was 45 percent more likely.

RMS defended its new model by suggesting it had brought scientists together for a formal, structured debate.

Elsner disputes that idea.

"We were just winging it," he said.

PREDICTING APOCALYPSE

In the Oz of insurance, RMS is the man behind the curtain.

The company is a Silicon Valley prodigy created 22 years ago by four Stanford graduates and their engineering professor, who parlayed a research project into a commodity: calculating earthquake probabilities and selling them to the insurance industry.

It was a short leap from there to run odds on just about every terrible and unlikely event, from Florida hurricanes to Japanese typhoons to European tempests, what RMS CEO and co-founder Hemant Shah calls a "full portfolio of apocalyptic hazard events."

The company Shah started from his California apartment is now a $200 million-a-year enterprise. Major insurance and reinsurance companies the world over pay annual subscriptions of $1 million or more to lease RMS' disaster-predicting software.

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 disband the long-term outlook. Insurance insiders wanted something they believed would be more accurate. And they wanted it to forecast hurricane activity for next few years based on current conditions, not simply assume history would repeat itself.

The pressure came from several places. Some reinsurers sought validation that global warming was increasing the threat of hurricanes. Others in the industry wanted a short-term model to encourage investors, who wanted odds on their returns in the near term.

Shah says he had an obligation to pursue the short-term model because of the belief that hurricanes had gotten more dangerous.

"How are you going to incent people to mitigate their homes if you don't have the right kind of signaling on what risk really is?" he told the Herald-Tribune in 2008.

An accurate prediction of the near future could save insurers 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 researcher Robert Muir-Wood wrote in a February 2006 column, "is likely to be the most eagerly awaited model ever introduced into the reinsurance market."

RUSHING TO RAISE RATES

Records show reinsurers and insurers did not wait.

Using numbers RMS provided in its promotional materials, they began increasing their own hurricane loss estimates 30 to 40 percent, six months before the new model was finished in May 2006.

Florida insurers in turn sought rate boosts in anticipation of what the new model would do to their own costs.

But the 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 is the single largest threat of insolvency to an insurance company," Devin Inskeep, senior financial analyst at A.M. Best, said in an interview.

According to a confidential presentation one of its officers gave an industry think tank, RMS calculated its new hurricane model raised the expected cost of a ma-

See **MODELS** *on 15A*

A price based on a dubious model

MODELS *from 14A*

jor 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 $82 billion to remain solvent.

RMS' two chief competitors argued there was inadequate scientific grounding to heavily promote a five-year outlook.

Clark, at the time CEO of AIR Worldwide, said she urged A.M. Best to reconsider requiring a model "based on theories."

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 Eqecat 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 in Florida.

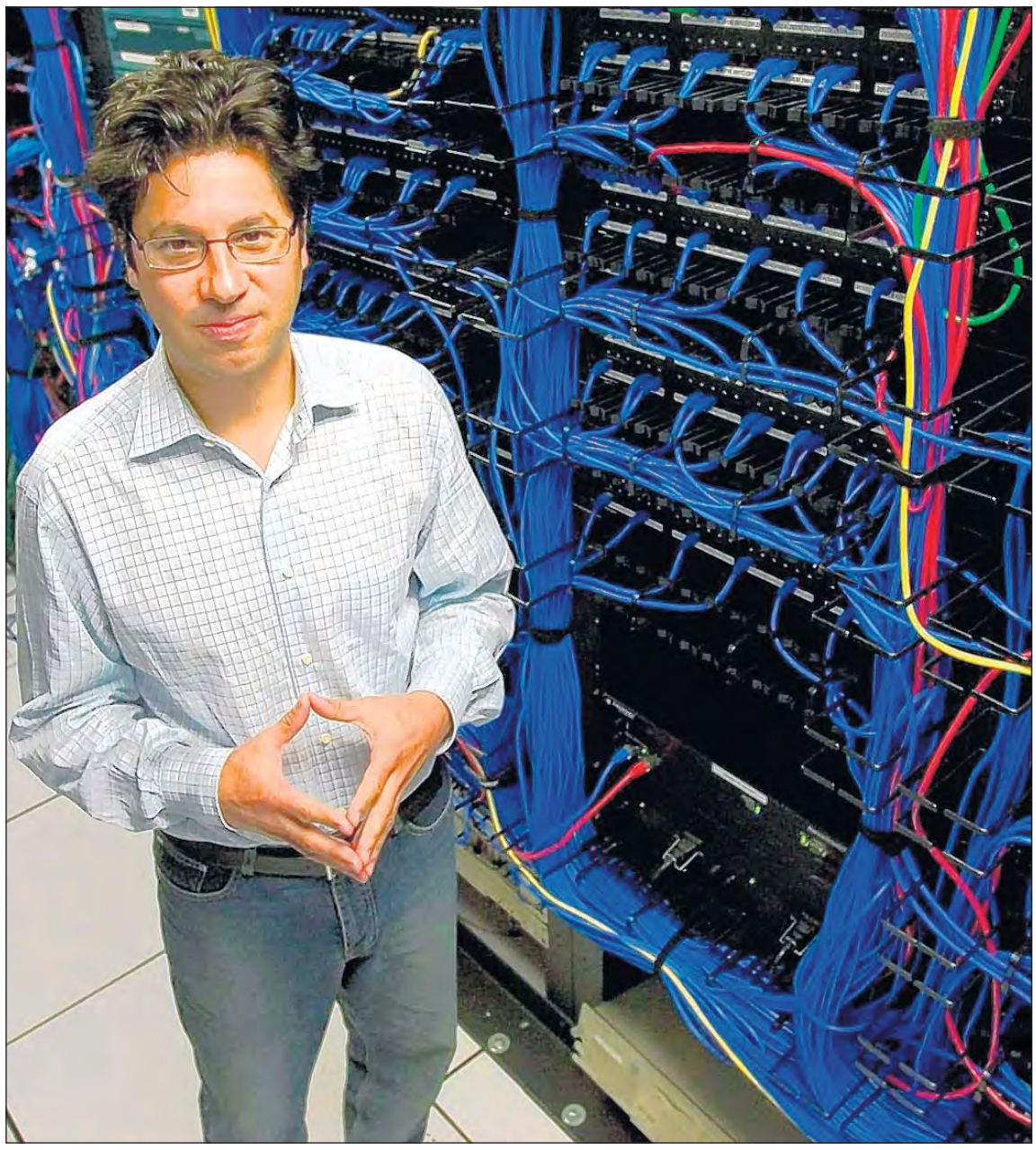
In a calculation Florida regulators learned about two years later, State Farm added a $1.5 billion "frequency adjustment" to its potential hurricane losses. That, in turn, required it to buy more reinsurance from its parent, a cost that resulted in a 47 percent rate increase to its Florida customers.

Allstate increased the loss estimates of its long-term hurricane model by 41 percent, a "climate cycle" adjustment it only briefly noted within its 4,000-page request for a 22 percent rate hike.

By the time the actual model was released in May 2006, it had already reshaped the Florida property insurance market, unleashing the largest spike in premiums in state history.

Florida has a law intended to prevent just such chaos.

A state commission must review and approve catastrophe models before insurers may use them to set rates. No short-term model has ever passed that test.



The computers at Hemant Shah's RMS contain models of virtually every U.S. disaster in the last 200 years. His company's predictions have helped reshape the industry. *LOS ANGELES TIMES / RANDI LYNN BEACH*

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 were invited.

Shah later told the Herald-Tribune he believed Florida was "mucking things up," suppressing a credible view of risk "so pricing can be more affordable."

"If you artificially constrain your view of risk then you're not going to have the clarity of insight that suggests what really needs to be done to solve the problem," he said.

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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.

Insurance Commissioner Kevin McCarty, above, answers questions about weak insurance companies like the one funded by Sarasota's William Griffin, left.

ABOVE PHOTO PROVIDED BY COLIN HACKLEY, LEFT PHOTO MARK FOLEY

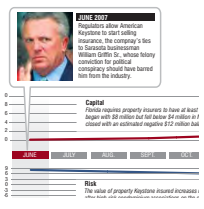
When these overextended insurers became unsound, Insurance Commissioner Kevin McCarty's office took extraordinary steps to keep them open. In lieu of cash and sound investments that could be used to pay claims, regulators sometimes counted questionable assets, including IOUs, real estate and tax credits.

The Herald-Tribune found evidence of these practices in five of the seven instances in which companies foundered 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 tougher? **11A**

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

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 details of how regulators handled those insurers remain sealed within confidential regulatory records. The exception is Keystone, whose closure is documented in thousands of pages that became public when the company was forced into liquidation last fall.

The records show Florida insurance regulators will grant a failing insurer great latitude, giving it chance after chance to stay open while customers remain at risk.

For months, Florida's top insurance administrators failed to heed warnings from their own financial experts and aided Keystone when they knew it was essentially bankrupt. And they allowed the crippled insurer to keep renewing policies.

Not once did homeowners receive a warning of their peril.

"I hate to say it, but that's what the state of Florida allows is this crap," said Michael Clarkson, a Clearwater insurance agency owner who tried unsuccessfully in 2008 to call regulatory attention to Keystone.

Administrators at the Office of Insurance Regulation say they do their best under difficult circumstances.

They believe it is more damaging to suddenly close a company and dump large numbers of policyholders back onto the state than it is to let a failing company take a year to silently wind down while seeking a buyer.

Regulators say they are trying to more aggressively go after weak companies but also say legal hurdles to shut down a company are steep.

"We look back like everybody else and try to see if there's more we can do, if there's something we didn't do right, if there's something more we could have done," said Deputy Insurance Commissioner Belinda Miller. "In retrospect, would any of these companies have been licensed? No. Not if we knew then what we know now."


Miller

Even so, Miller's staff argues homeowners were at minimal risk. They point out that even the most frail insurers are backed by reinsurance policies designed to pay the vast majority of claims after a hurricane. And even if insurers fail, homeowners who lose coverage are able to collect from Florida's insurance solvency fund.

But that taxpayer-supported fund covers only the first $500,000 in losses, leaving owners of larger homes unprotected. One in three home policies sold by Keystone exceeded this cap.

And records show the reinsurance coverage that regulators rely on does not always exist.

Keystone, for instance, canceled chunks of its coverage in 2009 and carried almost no protection for two storms, creating the potential to put billions of dollars of storm losses back onto Floridians.

PRESSURE TO APPROVE

When American Keystone was created in 2006, it was a godsend for state regulators.

The Office of Insurance Regulation had just shut down the insolvent Poe Insurance Group, leaving 320,000 policyholders without coverage. National carriers were fleeing the state en masse.

American Keystone offered to take on some of the least desirable of that business, first directly from Poe and later from Citizens Property Insurance, the state-run insurer of last resort for more than 1 million Floridians.

There was a catch. Regulators knew from the start that the people and money behind Keystone had connections to Sarasota entrepreneur William Griffin, whose 1999 federal conviction for generating illegal campaign contributions had banned him from the insurance industry for life.

Documents submitted to the Office of Insurance Regulation show the company was run by Griffin's son-in-law, controlled by Griffin's family trust and business associates, employed some of Griffin's friends, and was funded by a loan from a Griffin-created holding company formerly named Riscorp of Florida.

OIR solvency chief Robin Westcott required Griffin's son-in-law to step down as an officer of Keystone, the limit of what she said she could legally do. She said Griffin's own involvement in Keystone was never more than a suspicion.


Westcott

"I know my supervisor, my chief analyst, came in and said, 'We're not real sure. . . . ' " Westcott said.

Griffin provided a slightly different account. Department of Financial Services documents show he told a state fraud investigator he was a major investor in Keystone, but said his participation was "supervised and approved by state regulators and his attorney, therefore he thought his involvement was lawful."

For all the issues Griffin's involvement raised, Keystone offered Florida insurance regulators serious benefit.

The company proposed to take on the most toxic, untouchable hurricane risk in Florida: coastal condominium associations abandoned to Citizens Property Insurance.

The policies represent thousands of dollars each in premium, and millions of dollars of concentrated risk in perilous locations. More than 70 percent of that business in Florida sits in the government-run Citizens. No private carrier will take it.

Regulators knew Citizens did not have the cash to pay those policies if a major storm struck. Floridians would likely wind up paying billions of dollars for a bailout.

Keystone was the first — and so far only — carrier to offer to take over these policies from Citizens.

"So the pressure for us: Is there a way for us to allow takeouts?" said Westcott. "I think that was the reasoning on this. This company did have the reinsurance to do this."

CLEAR WARNINGS

Twice, Westcott agreed to move chunks of Florida condominium policies into the newly formed Keystone.

Agency correspondence files obtained by the Herald-Tribune show she did it despite objections and warnings from insurance regulation staff and officials at Citizens.

In April 2008, the manager of Citizens' policy assumption program, Lee Stuart, complained OIR was forcing Keystone's approval even though the company had missed four of five deadlines in the application process.

Stuart warned that policyholders should not be turned over to a company unable to meet simple bureaucratic requirements.

He was overruled. Westcott cleared Keystone to take over coverage of as many as 718 condominium associations, representing an estimated 47,000 residences.

Almost immediately, Keystone sought a second round of condominium policies from the state. Financial experts working for Westcott expressed alarm at the company's shrinking surplus and its chronic losses. The insurer was operating with only $500,000 more than it needed to avoid losing its license.

"As I said before, I'm concerned," analyst Carolyn Morgan wrote to Westcott on July 1, 2008. "This company has no room for error."

The following day, OIR analyst Jay Ambler finished his own review of Keystone's deteriorating financial condition and raised the insurer's risk level.

Ambler's official report ended with a recommendation that Keystone's request for more state-provided policies be denied.

A day later, July 3, Westcott approved the takeout, citing the company's promises to buy reinsurance.

The Herald-Tribune obtained a copy of Ambler's original report. A subsequent version no longer included the call for a denial.

"Maybe he changed his mind," said Miller, the deputy insurance commissioner. "I don't think it's a fair characterization that we weren't listening to staff."

Keystone's financial situation only grew worse.

Financial statements subsequently filed with state regulators show the company's condition deteriorated rapidly from July to November 2008. Its surplus fell below the legal minimum to $3 million, a level that had it been revealed at that time would have put the company out of business.

Keystone responded with an aggressive plan for growth. Sales fliers circulated by agents show the company offered to insure high-risk condominium associations in some of Florida's riskiest locales at below-market prices. It lured in thousands of new policies worth millions of dollars in premium, doubling the risk it carried, and doubling the number of Floridians in jeopardy.

Insurance experts say such pricing is a hallmark of desperation to generate cash.

"This is scary, because all of us will basically pick up the tab again while several whom become wealthy will hardly care," Clearwater agency owner Michael Clarkson wrote in a Dec. 4, 2008, warning to regulators at three state agencies.

Clarkson forwarded to the OIR copies of what he said were Keystone's unscrupulous offers, deals to cover risky properties at rates as much as 40 percent below what residents would have to pay elsewhere.

The papers landed on Miller's desk. Files show she asked Westcott to investigate. "Please find out what American Keystone is up to," she wrote.

"We are looking into this," an aide replied.

There is no further record of a review.

When asked if such a review was conducted, Westcott would only say there are many internal discussions not reflected in agency records, and that those regarding Keystone were numerous.

TURNING A BLIND EYE

As American Keystone's finances got worse, the Office of Insurance Regulation could have quickly stepped in to try to close the company.

But the OIR, which is responsible for protecting consumers from dangerous insurers, rarely takes that step.

In December 2008, Keystone still lacked the $4 million state law requires insurers to set aside at all times.

To stay in business, it sought permission to count two unusual assets: a $1 million IOU from an affiliated company, and a Sarasota medical office building owned by William Griffin, the man banned from insurance.

The 40-year-old building was priced by Griffin at $2.6 million but carried $1.3 million in debt. The value of the building exceeded state limits on the amount of surplus an insurer can tie up in real estate.

In addition, the building was parked in one of the most depressed real estate markets in the country, presenting a liquidity challenge if Keystone actually needed to sell the building to pay claims.

OIR staff noted both negatives. Nevertheless, their superiors agreed to allow the assets, which freed Keystone to write even more policies.

Despite having doubled the amount of premium it collected, Keystone continued to lose money, and its steps to appear solvent became riskier.

By April 2009, the insurer told regulators, it began to drop some of the reinsurance coverage it had bought to help pay future hurricane claims.

OIR held off aggressive action while company officers promised they were overseas seeking new investors in London.

But Westcott's staff expressed doubts.

"Given the company's performance and approaching storm season the analyst cannot believe this is a possibility," department staff wrote in the OIR's April 2009 supervisory plan for the troubled insurer.

In July, regulators discovered Keystone had less reinsurance than it had stated, and that its finances were in worse shape than previously revealed.

A later report from an independent consultant hired by the state to review Keystone's contracts showed that by July the insurer had no protection for tropical storms that caused less than $11 million in damage, and even less protection if a second storm struck that same year.

Regulators began an order to suspend Keystone. Westcott edited the draft agreement, penciling in her own words declaring Keystone "hazardous or injurious to its policyholders and to the public."

On Thursday, July 29, the Office of Insurance Regulation issued that order suspending American Keystone, demanding it stop writing policies and giving it five days to tell existing policyholders they were in danger.

But the agency never acted on the order.

By the following Monday, OIR lawyers were drafting a new, confidential order to vacate the suspension and keep Keystone in operation under state supervision.

The cause was Keystone. Miller said the company over the weekend had objected to the suspension but agreed to close down voluntarily by the end of 2009. Instead of initiating what could become a tough legal battle, Miller said, her agency accepted Keystone's proposal and made secret plans to move all Keystone storm victims into a state bailout fund should a storm strike.

As a result, Keystone — which regulators said at the time met the statutory definition of "impaired" — continued writing policies. That appears to violate state law, which makes it a felony for an impaired insurance company to sell or renew policies.

Despite the law, Keystone continued to accept homeowners' renewal checks, a source of income needed to pay the company's daily bills, including checks to Keystone's sister companies and a host of consultants with ties to Griffin.

Internal OIR memos show regulators at least three times noted the ongoing renewals, sometimes with surprise, and sometimes with disagreement about whether the practice should continue.

Yet they did not stop it.

It was not until Sept. 29 that Miller ordered Keystone to stop renewing policies, as the agency began its own steps to close down the insurer.

Keystone was shuttered Oct. 9 by court order.

Some 7,600 policyholders, homeowners and associations representing an estimated 70,000 families, had 29 days to find replacement coverage.

In the course of the shutdown, Westcott's staff would conclude

See REGULATORS *on 12A*

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 Pafford, 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.

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A hardscrabble past powers Senate hopeful

SENDING BILLIONS OVERSEAS

By PAGE ST. JOHN, page.st.john@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 governing reliance on this profit-driven market is eroding its ability to withstand the next disaster.

In the past four years, Florida-based home insurers paid out $11 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 rules that are vastly lenient compared to those of 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 19 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, a year-

See INSURANCE on 10A

Guests mingle at a party thrown by Guy Carpenter & Co. at the reinsurance industry's annual Rendez-Vous de Septembre in Monaco. STAFF PHOTO: PAGE ST. JOHN

Insurance firms' cycle of sending billions overseas

Reinsurance drives rate hikes

Florida's reinsurance spending on remains at its backstop coverage against the largest of catastrophes. But in Florida, some insurers have used it to cash out of the state, making off with billions of dollars paid by Floridians for the protection. Now, the state's reliance on reinsurance is essentially barrow money to write more policies. The rates homeowners pay reflect these strategies.

Cumulative rate increases

Traditional approach — First Floridian Home & Auto: This once-mighty Tampa member of Florida's insurance industry has been losing market share from big reinsurance

Leveraging — State Farm: Florida's biggest insurance company, with 1.5 million policyholders, has been using its parent company's deep pocketed reinsurance. That gave it the backing to write 10,000 new policies each month — a feat it could never accomplish with its own limited capital. Its leveraging has decreased its reinsurance

The exit strategy — Universal Property & Casualty: Universal's transformation into a reinsurance company has been a quick-to-profit strategy. The Miami-based insurer has shifted its business from primary reinsurance. Last year, it's backing to write 10,000 new policies each month — a feat it could never accomplish with its own limited capital. Its leveraging has decreased its reinsurance

Reinsurance

Floridians are paying more for reinsurance in total dollars and as a percentage of their total insurance bill.

Reinsurance — Total, in billions

Percent of premium — In reinsurance

Hurricanes Charley, Frances, Jeanne, Ivan, Dennis, Katrina, Rita, Wilma

Source: Florida Office of Insurance Regulation and Rejay

Surplus

Insurance companies are capping money that could have built reserves for the state. Insurance reserves have not increased since the 2004-05 hurricane seasons.

Policyholder surplus — In programs selling (all $100 program)

Source: Rejay Analysis of insurance and reinsurance data from Florida Office of Insurance Regulation

Graphic by Jeff Ward, Herald-Tribune staff

Florida's hurricane protection moves overseas

Since 2004, Florida homeowners have paid more than $10 billion in reinsurance, making Florida the single largest reinsurance buyer in the world. With no storms since 2005, Floridians have lost nearly every dollar they paid since then to foreign corporations and their investors.

Source: Business Insurance www.businessinsurance.com

Formula reinsurers

1. Lloyd's of London — Lloyd's is a market for insurance and reinsurance where many companies underwrite risks. Lloyd's is a market, not a company. Its 52 syndicates, the basic business units, underwrite insurance and reinsurance in 100 classes of business. Lloyd's underwrote $14.2 billion in premiums in 2009.

2. Berkshire Hathaway — Warren Buffett's company is a holding company that owns insurance companies and other businesses. Its insurance operations underwrote $4.7 billion in premiums in 2009.

3. Munich Re — Based in Munich, Germany, it is the world's largest reinsurer. It underwrote $19.2 billion in premiums in 2009.

4. Swiss Re — Based in Zurich, Switzerland, it underwrote $14.2 billion in premiums in 2009.

5. General Re — Through its U.S. subsidiary, the Stamford, Conn.-based General Reinsurance Corporation, it underwrote $1.9 billion in premiums in 2009.

6. Hannover Re — The largest reinsurer of Florida risk in the world. Florida has collected $1.9 billion from Florida insurers in 2009.

Jeb Bush sought federal solution

How we did the math

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.

Reinsurance executives and brokers mingle for a week every September in Monte Carlo. Their talks are a step toward the contracts that affect Florida insurance rates. *STAFF PHOTO / PAIGE ST. JOHN*

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

INSURANCE *from 1A*

bating 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 erage 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.

See **INSURANCE** *on 11A*

Florida's extensive spending on reinsurance helps fund the industry's annual gathering at Monte Carlo.
STAFF PHOTO / PAIGE ST. JOHN

INSURANCE *from 10A*

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 . . ."