

Depopulation Program Analysis

Depopulation Committee

September 6, 2012

Background

- Unlike a private insurer, Citizens does not have the ability to manage its book of business – Citizens accepts most risks and its wind risk far exceeds its surplus and reinsurance.
- Citizens has contingent capital in the form of assessments to ensure adequate claims paying resources.
- While Citizens is in its best ever financial position, we continue to rely on assessments to fund catastrophe losses in the event of a large storm or several smaller storms.
- Consideration of the impact on assessments must therefore underlie any depopulation initiative.

2012 Board of Governors Initiatives

- **Aggressively Transfer Risk to Private Markets**
 - Final placements reduced potential assessments after a large storm* by \$1.5B
- **Reduce Exposure**
 - In total, 31 separate initiatives have been filed by the Board
 - Coverage excluded for pool cages
 - Coverage excluded for personal residential homes \$1M+
 - Coverage excluded for some special class risk items
 - Combined changes reduced 1-in-100 year PML by approximately 5%
- **Increase Depopulation Activity**

* Large storm is considered a 1-in-50 year PML or greater

2012 Initiatives – *Increase Depopulation Activity*

Citizens has made several enhancements to its traditional depopulation program, including:

- Chairman re-instituted the Depopulation Committee
- Eliminated the standard 16% ceding commission (retroactively applied to the 4th quarter of 2011)
- Convened a Depopulation Summit
 - Solicited depopulation ideas
 - Obtained feedback on barriers to depopulation
- Improved depopulation communications with consumers
- Enhanced the volume and refinement of data used by take-out companies in evaluating assumed policies

2012 Initiatives – *Increase Depopulation Activity* (cont'd)

These enhancements have facilitated

- Assumptions totaling approximately **84,000** policies and **\$20.4B** in exposure (as of mid-2012)
- Anticipated assumptions of approximately **300,000** policies (contingent upon both existing and new programs November/December 2012)

*Assumptions year to date as of **June 30, 2011** and **December 31, 2011** removed approximately **22,000** and **53,000** policies, respectively.*

Proposed Program – *Potential Results from Citizens' Evaluation*

Results from analyses of the potential reduction in PLA exposure, assuming approximately **350,000** policies are removed and surplus notes of **\$300M*** are issued as the incentive mechanism:

Results Based on 1-in-100 Year PML	Before Surplus Note Program	After Surplus Note Program	Projected Surplus Note Program Change	
Emergency Assessment	\$3.06	\$1.89	(\$1.17)	-38.3%
PML	\$7.90	\$5.83	(\$2.07)	-26.1%

Notes

- ¹ All dollar amounts are in billions
- ² Assumes surplus note is carried at 50% of its face value
- ³ Projections depend on number and characteristics of policies removed

If Citizens depopulated under this proposal projection, it would invest **\$300M** into this program (20% of PLA surplus) where **emergency assessments could decrease by \$1.2B or (38%) after a 1-in-100 year event**

Assuming a rate online of 20%, it would cost Citizens appx. \$240 million **each year** to reduce this amount of PML through private reinsurance

New Depopulation Program(s)

- August 2012, Depopulation Committee meeting
- The Board of Governors charged staff with evaluating four depopulation proposals
- Staff was directed to evaluate each proposal's impact on:
 - Materially reducing Citizens' policy count and exposure to catastrophe loss, thereby reducing its reliance on assessments
 - Citizens' existing policyholders
 - Attracting new or additional capital to the state of Florida
- Staff was further directed to:
 - Make inquiries of the submitting entities
 - Better understand the intricacies of each proposal
 - Better understand the functionality of each program
 - Consider development of a separate proposal designed in Citizens' best interest of reducing policy count and wind loss exposure
- Objective: **Seek and evaluate every opportunity to reduce policies in force and potential for assessments**

New Depopulation Program(s) – *Evaluation Process*

In performing its initial evaluation of the proposals, Citizens' staff considered the following additional items that served as “guiding principles” during the evaluation process:

- Does the proposal provide for any risk to the proposing insurer
- Does the proposal require Citizens to build additional infrastructure or outsourcing to monitor the program
- Could the proposal be implemented by early December 2012
- Does the proposal, after various catastrophic event scenarios, reduce assessments
- Does the proposal require retention of policies
- Does the proposal contain a concise and measurable consequence if the insurer does not retain or replace policies assumed
- Does the insurer meet minimum financial requirements
- Does the proposal include elements that create legal or bond document risk

New Depopulation Program(s) – *Evaluation Process* (cont'd)

Lead Staff

- Sharon Binnun, *Chief Financial Officer*
- Jennifer Montero, *Sr. Director of Accounting/Controller*
- Fred Deeb, *Assistant Director of Accounting*
- Andrew Woodward, *Assistant Controller*

Citizens' Executive Review Team

- Barry Gilway, *President/Chief Executive Officer and Executive Director*
- Dan Sumner, *General Counsel/Chief Legal Officer*
- Susanne Murphy, *Chief Administration Officer*
- Yong Gilroy, *Chief Insurance Officer*
- Christine Ashburn, *Director of Legal/External Affairs*

Supporting Staff

- Brian Donovan, *Chief Actuary*
- Paul Kutter, *Actuarial Research Manager*
- Mona Markell, *Senior Actuarial Consultant*
- March Fisher, *Director of Corporate Analytics*
- Tonya Antoine, *Catastrophe Modeling Manager*
- Bethany Kocher, *Data and Analytics Manager*
- Keith Sandell, *GIS Manager*
- Janelle Versnick, *GIS Analyst*
- Chris Howell, *Director of ERM*
- Carol Williams, *ERM Manager*
- Raymond James (*Financial Advisor*)

New Depopulation Program(s) – *Evaluation Process* (cont'd)

- Additional staff within the *Legal, Consumer and Agent Services*, and *Analytic* business units were also involved throughout the evaluation process.
- In addition to Citizens' staff, outside counsel was engaged to perform independent analyses addressing:
 - Impact on tax-exempt status
 - Impact on current and future bond issuances
 - Citizens' enabling statute (i.e. reinsurance)

New Depopulation Program(s) – *Evaluation Process* (cont'd)

- **Staff conducted a comprehensive review of all proposals**
 - Generate a detailed summary of each proposal
 - Identify potential issues and/or risks
 - Draft follow-up questions
- **Met with members of the submitting entities to discuss results of Staff Review and how each proposal addresses the following:**
 - Time needed to implement
 - Reduction in exposure and reliance/likelihood of assessments
 - Impact to policyholders (current and assumed)
 - Sustainability of the proposal given various consequences (i.e. opt-outs, rate freezes, cat events)
 - Cost to Citizens and initial/future impact on surplus
- **Review other proposals submitted to Citizens**
- **Meet with FHCF (SBA) to discuss administration and structure of the capital build-up surplus notes program**
- **Perform a detailed financial analysis of each proposal to obtain the following:**
 - Specific PML/AAL reduction
 - Rate gap (need) by territory
 - Surplus reduction (i.e. net cash outflow to Citizens)
 - Impact on assessments
 - Stress test conclusions
- **Consult with the Office of Insurance Regulation at various decision points**
- **Consider other proposals received**

New Depopulation Program(s) – *Evaluation Process* (cont'd)

- Focus first on a specific proposal to best accomplish goal of PML reduction as quickly as possible
 - Perform complete review
 - Consider details including legal terms and conditions
 - Consider risk and mitigation thereof
- Consider next complementary program(s) to further reduce exposure, policy count and probability of assessments
- Recognize that some incentive mechanism must be included
- Result is a blend of proposals using a surplus note (loan) as the incentive mechanism for new depopulation program
- Ability to implement surplus note program for early December depopulation
 - Both existing and surplus notes programs
- Staff requests approval to continue to review other proposals and/or elements thereof to continue consideration of other programs, potentially including a direct reinsurance element

New Depopulation Program – *Surplus Notes Program*

Summary: remove significant number of policies from PLA and personal lines policies from Coastal Account by using a loan program (“surplus note”) as the incentive mechanism. The amount of surplus notes is generally based on the gap in Citizens’ rates and is risk-based.

- Applies only to personal residential policies
- Maximum of \$300 million and \$50 million of committed capital by Citizens within the PLA and Coastal Account, respectively
- Surplus note amount is a function of the exposure removed as well as policy wind risk
- Surplus note/loan term of 20 years
- Rate increases capped at 10% for 3 renewal cycles following assumption to encourage retention by assuming insurer
- Policies must be retained for at least 10 years; can accelerate principal payments or increase interest rate for non-compliance
- Minimum initial and continuing financial requirements for participants
- Does not require new/additional capital; could result in additional capital if applying insurer does not currently meet such requirements and infuses capital

New Depopulation Program – *Surplus Notes Program* (cont'd)

- Surplus note is a function of the exposure removed as well as policy wind risk; equal to the estimated FHCF premium (determined on a per-policy basis) multiplied by a factor of 4
- Surplus notes will be limited to \$50 million per assuming insurer
- Surplus note principal may be credited in an amount not to exceed 20% per year for the first 5 years in the event of a PCS-named Florida hurricane (risk sharing element)
- Citizens will initially “hold-back” 5% of the initial surplus note proceeds in consideration of opt-outs
- Program to launch in early December, concurrent with existing depopulation transaction date
- Minimum TIV removal of \$5.5 billion per assumption

New Depopulation Program – *Surplus Notes* Program (cont'd)

- **Staff independently considered factors from the position of a prudent investor**
- **Citizens Proposed Financial Requirements for participants:**
 - Must have been actively writing property business in Florida for the preceding **2 years**, and
 - Actual 2011 or projected 2012 Risk Based Capital (RBC) ratio of at least 300 **and** minimum surplus of \$25 million, **OR**
 - Actual 2011 or projected 2012 RBC ratio of at least 400 **and** minimum surplus of \$20 million, and
 - Must have Florida direct written property premium in 2010 and 2011 of at least **\$50** million, and
 - Maintain net catastrophe reinsurance retention of not more than **20%** of surplus, and
 - Reinsurance protection up to the 1:100 year and two 1:10 year PML levels including a factor for LAE, and
 - Cash and total invested assets (net admitted) to total liabilities of at least **1:1**, and
 - Liabilities to surplus of no more than **3:1**
 - Requirements are initial to qualify for program, continuing with certain exceptions after a cat event

New Depopulation Program – *Surplus Notes* Program (cont'd)

Other Considerations:

- Review of audited financial statements
- Writing ratios
- Tenure of management and Board of Directors
- Current levels organic and assumed business
- Number of appointed agents and demonstration of sufficiency of agency force
- Current and expected (after assumption) number of Florida employees
- Current and anticipated (after assumption) claims and underwriting operations
- Disclosure of off-balance sheet risks
- Compliance with State of Florida surplus notes contract if applicable

Surplus Notes Program – *Risks*

- Principal and interest payments are subject to OIR approval – if an assuming insurer is financially impaired, it may be difficult for Citizens to enforce its contractual right to payments (principal and interest)
- If a catastrophic event occurs in each of the five years after note is issued, Citizens may be in a position of crediting 100% of the principal
- Credit risk for proposed surplus note term of 20 years
- Despite contractual requirements, policies could return to Citizens if assuming insurer fails to retain
- The interest rate charged (approximately 2%) does not approximate the true market rate for similar debentures with similar credit and event-risk characteristics
- Using the FHCF times a factor of 4 may not categorically align with the actual rate gap for each policy
- Significant reliance on independent assurance (i.e. External Auditors) and regulatory oversight (i.e. OIR) of participants' control environment and activities
- Inaccurate or non-representative sample selected for audit may lead to incorrect calculation of note provisions
- Possible administrative errors due to the burden of tracking/monitoring status of potentially hundreds of thousands of policies under the program

Enterprise Risk Management (ERM) evaluated the proposed surplus notes program and provided an analysis of potential risks.

Surplus Note Program Application

An Interactive Program Application will be available at:

www.citizensfla.com/about/depoinfo.cfm

HEADER FOR
PROGRAM
APPLICATION

The screenshot shows a web browser window displaying the Citizens Florida website. The page title is "About Us - Depopulation / Policy Take Out - Mozilla Firefox". The URL is "https://www.citizensfla.com/about/depoinfo.cfm". The page features a navigation menu with links for Home, Policyholders, Agents, Adjusters, and About Us. The main content area is titled "Depopulation / Policy Take Out Information" and includes a "Select Subject:" section with links for "Frequently Asked Questions", "Statistics", "2012 Calendar", "Non-Bonus Takeout Plan", and "Links". A red arrow points from the text "HEADER FOR PROGRAM APPLICATION" to the "Frequently Asked Questions" link. Below the sidebar, there is a "Letters and Forms:" section with several links to sample letters and forms, and an "Overview:" section with a brief description of the Depopulation Program.

Appendices

Appendix 1: Surplus Notes Definition

Appendix 2: Selected Layer Charts

Appendix 3: Algorithm for Depopulation Policy Selection

Appendix 1 – Surplus Notes *Definition*

Surplus notes (surplus debentures, contribution certificates) are instruments that have the characteristics of both debt and equity. While surplus notes generally require the repayment of principal and interest (note that interest cannot compound), they are subject to the strict control of the commissioner of the reporting entity's state of domicile. In order for surplus notes to be included as **equity** (as opposed to **debt**) by the issuing entity, the following provisions must be included within the debenture:

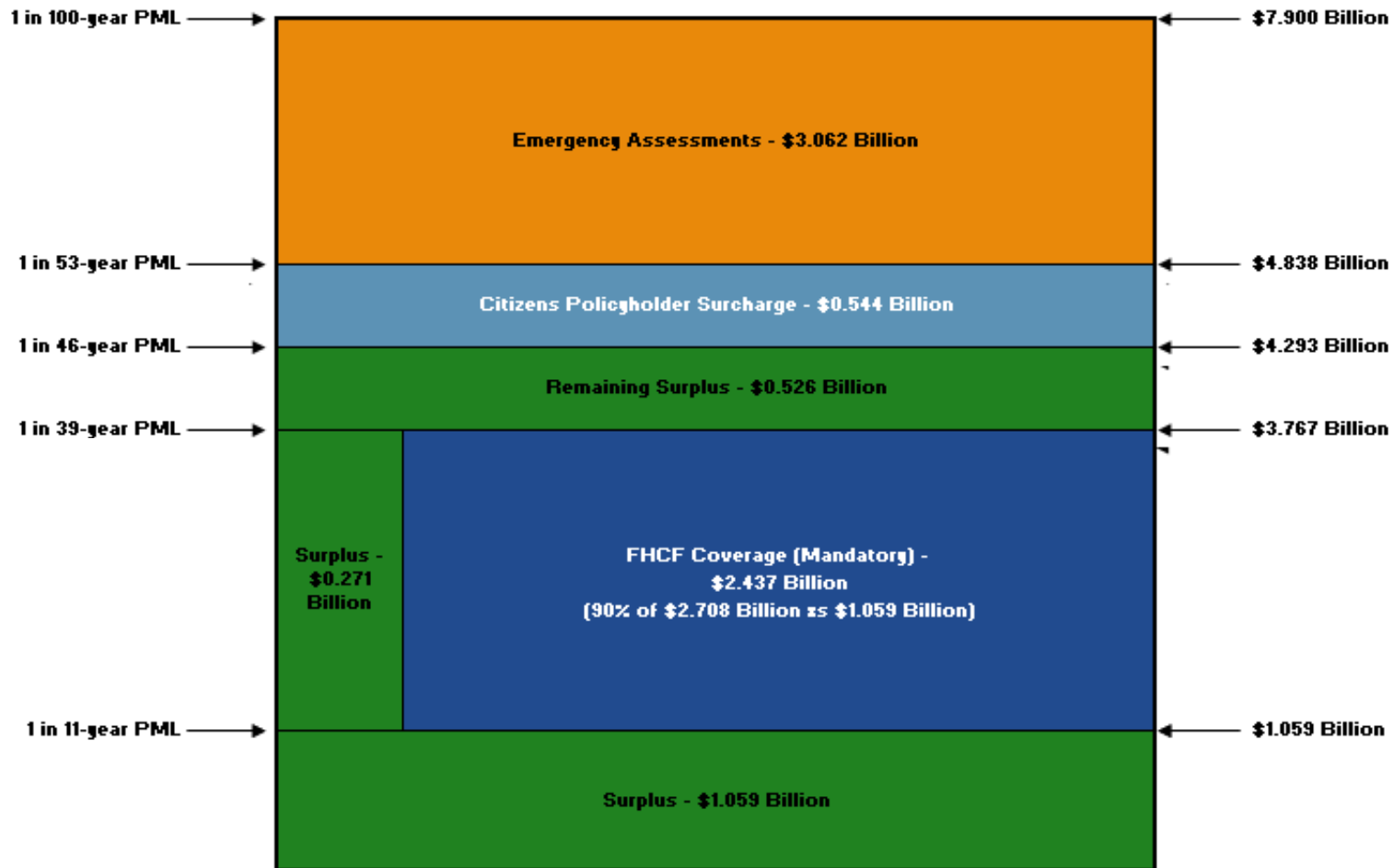
- Subordination to policyholders;
- Subordination to claimant and beneficiary claims;
- Subordination to all other classes of creditors other than surplus note holders; and
- Interest payments and principal repayments require approval of the commission of the state of domicile.

Additional considerations

- Surplus notes **cannot** be used for the purpose of initially capitalizing a stock reporting entity.
- Surplus notes are **not** considered part of the issuing entity's legal liabilities.
- Investments in surplus notes are considered admitted assets and follow the general accounting and reporting requirements of **Bonds** (excluding loan-backed and structured securities).
- Surplus notes are reported as **debt** by the issuing entity for GAAP reporting.
- Interest and principal can only be recorded as a liability upon approval for payment by the commissioner in the state of domicile.
- Citizens may have to record a discount (i.e. valuation allowance) to the surplus notes (thereby reducing surplus) since the market (fair) value will likely be less than the face value

Appendix 2 – Current Estimated PLA 2012 Liquidity & Claims-Paying Resources (1-in-100 Year Event)

Illustrative Purposes Only: PLA/CLA are combined for actual FHCF Coverage



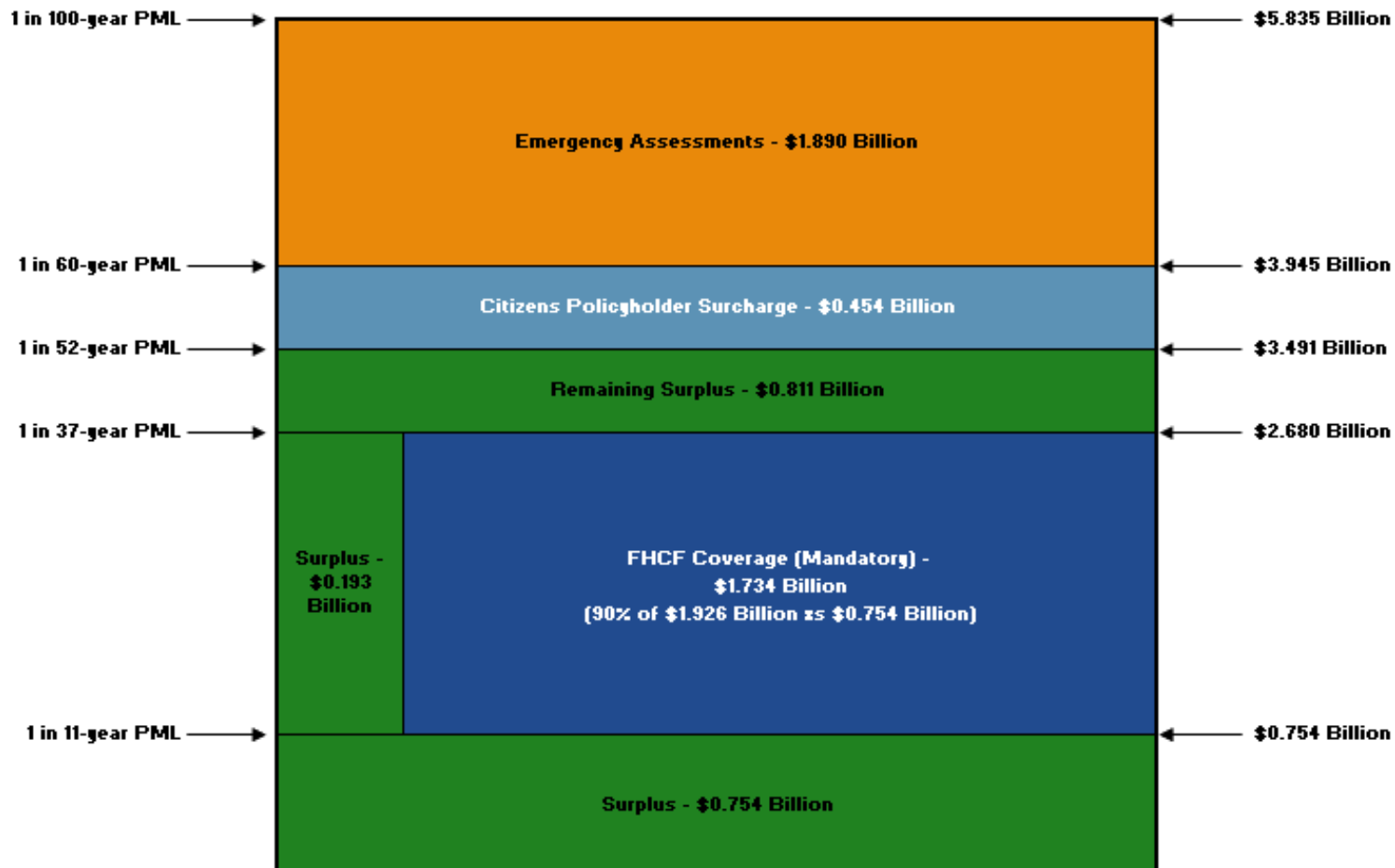
Note 1 → FHCF coverage is based on preliminary retention and payment multiples. The actual retention and limits may be significantly different from these estimates. This layer chart is not drawn to scale.

Note 2 → Modeled PMLs are weighted 1/3rd Long-Term and 2/3rd Near-Term, reflect Single-Event Occurrences and are based on exposures as of December 31, 2011.

Note 3 → Emergency Assessments are the maximum annual amount allowed by Florida Statutes (10% per account). However, Emergency Assessments could potentially be recovered over many years.

Appendix 2 – Potential Estimated PLA 2012 Liquidity & Claims-Paying Resources After Surplus Notes Program (1-in-100 Year Event)

Illustrative Purposes Only: PLA/CLA are combined for actual FHCF Coverage



Note 1 → FHCF coverage is based on preliminary retention and payment multiples. The actual retention and limits may be significantly different from these estimates. This layer chart is not drawn to scale.

Note 2 → Modeled PLA PMLs are weighted 1/3rd Long-Term and 2/3rds Near-Term, reflect Single-Event Occurrences and are based on exposures as of December 31, 2011 less projected depopulation.

Note 3 → Emergency Assessments are the maximum annual amount allowed by Florida Statutes (10% per account). However, Emergency Assessments could potentially be recovered over many years.

Note 4 → Assumes 350,000 policies are depopulated. \$307 million in surplus notes are issued and valued at 50% of the notes. Surplus decreased by 50% of surplus notes and increased by reduction in FHCF premium.



Appendix 3 – Depopulation Algorithm

When multiple takeout companies select the same policy from the policies eligible to be assumed on a particular assumption date, Citizens utilizes a methodology to assign the policy to one of the takeout companies.

Typically, there are many instances of individual policies being selected by multiple takeout companies; however, a policy can only be assumed by one takeout company on a specific assumption date.

The depopulation algorithm attempts to allocate the policies to the various takeout companies that selected them by following the steps below:

1. Identify policies selected by multiple takeout companies
2. Group policies into batches based on the number of companies that selected them
3. Sort the policies within each batch by policy form, zip code and total premium
4. Assign each policy to one of the companies that selected it in a manner that results in the most equitable split of premium amongst the companies.

Note that a takeout company will not be assigned a policy they did not select. Additionally, a takeout company may not receive all of the policies they select due to the possibility of duplicate selections.