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Florida Bypasses Buffett as Hurricane Bonds Rally: Muni Credit

By Toluse Olorunnipa - May 29, 2014

In 2008, Florida's government-run property insurer paid Warren Buffett $224 million to agree to buy its debt if a major storm struck. Six hurricane-free years later, the state is turning investors away.

With hurricane season set to start June 1, municipal securities sold by Florida's taxpayer-owned property insurers are rallying, and the state boosted a catastrophe-bond sale last month by almost four times, to $1.5 billion.

Florida, typically the nation's most hurricane-prone state, is benefiting from a thirst for yield as investors seek higher returns with municipal interest rates close to generational lows. The demand is bolstering state-run Citizens Property Insurance Corp. and the Florida Hurricane Catastrophe Fund Finance Corp., which have record cash reserves.

"We haven't had a hurricane make landfall in eight years," said Jack Nicholson, who runs the catastrophe fund from Tallahassee. The taxpayer-owned entity provides backup coverage for insurance companies. "I'd rather be lucky than smart any day."

The last hurricane to strike Florida was Wilma in 2005. If the streak ends this year, the fourth-most-populous state may need to sell bonds for recovery costs. Dwindling issuance in the $3.7 trillion municipal market and investors' search for yield bodes well for the catastrophe fund, according to Bank of America Corp., JPMorgan Chase & Co. (JPM) and Wells Fargo & Co. (WFC)

Andrew's Legacy

The banks, which underwrite the reinsurer's bonds, estimated on average that the fund would be able to sell $8.3 billion of debt within a year to meet its obligations after a hurricane. That's more than twice what the fund would need to borrow if it runs out of cash.

The catastrophe fund was created by the state in 1993, a year after Hurricane Andrew ravaged Miami. The fund, which has about $11 billion in cash, is obligated to pay out as much as $17 billion for this hurricane season.

In 2008, it had $3.6 billion in cash to cover $29 billion in potential liabilities. The U.S. was in the first year of the longest recession since the 1930s and Nicholson wasn't sure if investors would be willing to finance the gap after a major storm.

Buffett Deal

Florida cut a deal with Buffett's Berkshire Hathaway Inc. (BRK/B), paying the Omaha, Nebraska-based company in exchange for a guarantee that it would buy the state's bonds if a storm caused more than $16 billion in losses.

Buffett, 83, whose $65.3 billion net worth makes him the world's third-richest person, didn't respond to a request for comment sent to an assistant.

The state of about 19.6 million people won't need special deals to attract investors this year because of pent-up demand for higher-yields, said Michael Schroeder, chief investment officer at Naples, Florida-based Wasmer, Schroeder & Co.

If the catastrophe fund were to issue federally taxable 30-year bonds this year, they'd probably carry interest rates about 2.50 percentage points more than benchmark Treasuries, Bank of America estimated in a May 1 letter. Benchmark Treasuries maturing in 2044 yield about 3.3 percent.

The fund's bonds, which are exempt from state taxes, are rated Aa3 by Moody's Investors Service, fourth-highest.

Interest Abounds

"If they had to do a deal today, it would not be a problem," said Schroeder, whose firm manages about $3.5 billion in munis, including Florida hurricane bonds. "You'd have a significant number of players that would be interested."

Texas, North Carolina and Louisiana also have systems to provide insurance in high-risk areas. California offers state-run earthquake insurance.

Citizens Property, which offers Florida homeowners direct coverage, is also benefiting from investors' willingness to take on hurricane-linked risk. The insurer increased the size of its catastrophe bond offering to a record $1.5 billion last month, after initially marketing $400 million, said Jennifer Montero, its chief financial officer in Tallahassee.

"We were oversubscribed," she said. "There's so much money that investors don't know where to put it."

The taxable three-year bonds priced to yield 7.5 percent, she said.

Risk Appetite

Catastrophe bonds offer higher returns in exchange for risking the loss of principal. If hurricanes or other disasters cause a specified amount of damage, insurers can use the principal to cover recovery expenses. Holders of the Florida bonds face a 1.7 percent chance of losing their entire principal, according to Citizens.

More buyers are willing to take that risk, said Caleb Wong, who helps oversee catastrophe bonds at New York-based OppenheimerFunds Inc., which manages $237 billion.

"The fact that there has been no sizable event in Florida recently, I think that has had some impact in drawing some investors," he said.

The catastrophe bonds helped Citizens' balance sheet, which also includes a record $7.6 billion in cash and proceeds of $1.5 billion in munis issued in 2012. Fitch Ratings gave the Citizens debt its fifth-highest grade, pointing in part to the cash stockpile. Citizens, which was created in 2002, is the state's largest property insurer, with 940,000 policies.

"They're at the point that they could deal with what they estimate to be a once-in-100-year storm without having to go to the market," said Karen Krop, a Fitch analyst.

Bond Backing

The catastrophe fund and Citizens repay bonds by levying assessments on owners of homes and cars.

Citizens last sold tax-exempt municipal bonds in June 2012. The catastrophe fund last sold debt in April 2013, raising $2 billion.

Federally taxable bonds issued by the catastrophe fund that mature in July 2020 traded this week with an average yield of 2.66 percent, matching the lowest since their issue last year, data compiled by Bloomberg show. The yield was about 0.9 percentage point above Treasuries, down from about 1.8 percentage points at issue.

Both the fund and Citizens have amassed record cash reserves during the eight-year span without hurricanes. Combined, they have more than $18.5 billion available to pay claims.

1992 Reminder

That may not be enough, as a direct hit to a population center like Miami could cause more than $80 billion of damage, according to state estimates. Andrew in 1992 caused more than $45 billion of damage in the Miami area, adjusting for 2010 prices, National Weather Service records show.

Three to six hurricanes will probably form in the Atlantic this year, the National Oceanic and Atmospheric Administration predicted May 22. One or two may qualify as major, with winds of 111 miles (179 kilometers) per hour or more. The Atlantic season runs through November.

Florida's streak of seasons with no hurricanes is a record, according to data from the National Hurricane Center. From 1851 to 2004, 273 hurricanes struck the U.S. mainland, according to the center. Florida was hit more often than any other state, with 110 hurricanes making landfall.

The unpredictability of hurricanes can be a draw, as weather isn't correlated with financial risks such as recessions, said Schroeder. And with municipal issuance dwindling, buyers may pounce on bonds issued to pay for a destructive hurricane.

Schroeder doesn't count himself among investors eager for that opportunity, he said from his office along the west coast of Florida.

"It would do a lot of damage," he said.

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