Citizens Property Insurance Corporation
Management Discussion and Analysis for 2017
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The following provides an assessment by management as to the financial position, results of operations, cash flow and liquidity of Citizens Property Insurance Corporation (Citizens). Information presented in this assessment supplements the financial statements, schedules and exhibits contained within Citizens' 2017 Annual Statement.

COMPANY BACKGROUND

Citizens was established on August 1, 2002, pursuant to Section 627.351(6), Florida Statutes (the Act), to provide certain residential and non-residential property insurance coverage to qualified risks in the State of Florida under circumstances specified in the Act. The original intent of the legislation was that property insurance be provided through Citizens to applicants who are in good faith entitled to procure insurance through the voluntary market, but are unable to do so. Citizens results from a combination of the Florida Residential Property and Casualty Joint Underwriting Association (FRPCJUA) and the Florida Windstorm Underwriting Association (FWUA). The FRPCJUA was renamed Citizens and the FWUA's rights, obligations, assets, liabilities and all insurance policies were transferred to Citizens. Unlike private insurers offering coverage through the admitted market, Citizens is not required to obtain or to hold a certificate of authority issued by the Florida Office of Insurance Regulation (the Office). For purposes of its tax-exempt status, Citizens is considered a political subdivision and an integral part of the State of Florida. As such, Citizens' operations may be affected by the legislative process. Citizens operates pursuant to a Plan of Operation (the Plan) approved by the Financial Services Commission (the Commission) of the State of Florida. The Commission is composed of the Governor, the Chief Financial Officer, the Attorney General and the Commissioner of Agriculture of the State.

Citizens is supervised by a Board of Governors (the Board) which consists of nine individuals who reside in the State of Florida. The Governor appoints three members, and the Chief Financial Officer, the President of the Senate and the Speaker of the House of Representatives each appoint two members of the Board. At least one of the two members appointed by each appointing officer must have a demonstrated expertise in the insurance industry. The Chief Financial Officer designates one of the appointees as the Board's chair. All Board members serve at the pleasure of their appointing officers. As of the end of 2017, one of the nine Board member appointments was vacant.

Citizens' President and Chief Executive Officer (Executive Director) and senior managers are engaged by and serve at the pleasure of the Board. The Executive Director is subject to confirmation by the Florida Senate. Pursuant to the Act, all revenues, expenses, assets and liabilities of Citizens shall remain divided into three separate accounts: the Personal Lines Account, the Commercial Lines Account and the Coastal Account. A brief history of each account follows:

Personal Lines Account – The FRPCJUA began operations on January 21, 1993, after Hurricane Andrew, pursuant to Section 627.351(6), Florida Statutes, to provide certain residential property insurance coverage to qualified risks in the State of Florida for applicants who were in good faith entitled to procure insurance through the private market but were unable to do so. Residential property coverage consists of the types of coverage provided to homeowners, mobile homeowners, tenants, condominium unit owners, and similar policies. The policies provide coverage for all perils covered under a standard residential policy, subject to certain underwriting requirements. Such policies may exclude windstorm coverage on property within eligible areas. This portion of the FRPCJUA's activities became the Personal Lines Account (PLA) under Citizens.

Commercial Lines Account – The Florida Property and Casualty Joint Underwriting Association (FPCJUA) was activated in early 1994 to provide commercial residential coverage (i.e. coverage for condominium associations, apartment buildings and homeowner associations) to organizations unable to obtain such coverage from a private insurer. During 1995, legislation was enacted to transfer all obligations, rights, assets, and liabilities related to commercial residential coverage from the FPCJUA to the FRPCJUA. The legislation required that the premiums, losses, assets and liabilities be accounted for separately from the FRPCJUA's personal residential business. This portion of the FRPCJUA's activities became the Commercial Lines Account (CLA) under Citizens. In 2006, the FPCJUA was re-activated to provide commercial non-residential wind-only coverage. In 2007, legislation was enacted which resulted in the transfer and assumption of the FPCJUA's commercial non-residential policies by Citizens. These policies were added to the CLA.

Coastal Account **–** The FWUA, which was a residual market mechanism for windstorm and hail coverage in select areas of the State, was created by an act of the Florida Legislature in 1970 pursuant to Section 627.351(2), Florida Statutes. The FWUA was a Florida unincorporated association, the members of which were all property insurance companies holding a certificate of authority to provide property insurance coverage in the State. The FWUA provided policies of windstorm insurance for property owners within the eligible areas who were unable to obtain such coverage from private insurers. Insured properties include personal residential, commercial residential and commercial non-residential properties. This portion of the FWUA's activities became the High-Risk Account (HRA) under Citizens. In 2007, Citizens received authority to issue multi-peril policies in the HRA. Pursuant to legislative changes during 2011, the HRA was renamed the Coastal Account.

The Florida Legislature authorized Citizens under section 627.3518 F.S., to create a clearinghouse program to confirm eligibility of new applicants to Citizens and to provide new applicants and existing Citizens policyholders enhanced access to offers of coverage from authorized insurers. Under the program, authorized insurers that have voluntarily agreed to participate in the program are able to make offers of coverage to new applicants and existing Citizens policyholders that may render their property ineligible for coverage with Citizens. Fifteen carriers now participate in the Clearinghouse.

The Property Insurance Clearinghouse launched with HO-3 on January 27, 2014. Since then, DP-1, DP-3, HO-6, HW-2 (wind-only homeowners) and HW-6 (wind-only condominium owners) policy types have been added. Since inception, approximately 64,000 new business and renewal risks representing $15.3 billion of Coverage A exposure have been re-directed to the private market.

Policy types offered by Citizens, by account, are as follows:

Personal Lines Account	Commercial Lines Account	Coastal Account
Homeowners (HO-3) Modified Homeowners (HO-8) Dwelling Fire (DP-1 and DP-3) Condo Unit Owners (HO-6) Mobile Homeowners (MHO-3) Mobile Home Dwelling Fire (MDP-1) Tenant (HO-4) Mobile Home Tenants (MHO-4)	Commercial Residential Policies (excludes liability coverage) Commercial Nonresidential Policies (commercially operated nonresidential property)	All policy forms of the PLA and CLA within "Eligible Areas"** Personal Residential Wind-Only Homeowners (HW-2) Tenant (HW-4) Condo Unit Owners (HW-6) Dwelling (DW-2) Mobile Home (MW-2) Mobile Home Dwelling (MD-1) Commercial Wind-Only: Commercial Residential Commercial Nonresidential

***"Eligible Areas" currently include portions of 29 of Florida's 35 coastal counties, including all of Monroe County and the area within Port Canaveral; in Miami-Dade, Broward, and Palm Beach Counties, all of the areas east of I-95 are eligible (in some instances extends as far as five miles from the coast); elsewhere in the State, coverage is generally limited to a distance within 1,000 to 1,500 feet from the coast.*

Net premiums earned by line of business for 2017 and 2016, are as follows:

Line of Business	2017 Net Premiums Earned	%	2016 Net Premiums Earned	%
	(in thousands)		*(in thousands)*	
Fire	$ 27,985	4%	$ 38,182	6%
Allied*	252,326	40%	266,392	43%
Homeowners multi peril	346,135	55%	320,966	51%
Total	$ 626,446	100%	$ 625,540	100%

*Includes wind-only policies classified as *Allied*

CATASTROPHE RISK MANAGEMENT

As a statutorily-created entity that provides insurance coverage to those unable to secure insurance coverage in the private market, Citizens has limited capabilities in managing its direct exposure to hurricane risk. In order to mitigate its net exposure to hurricane risk, Citizens participates in the risk transfer market as a cedent in both traditional and capital markets. In 2017, Citizens' total risk transfer program amounted to $1.33 billion, representing a $1.13 billion (46%) decrease relative to 2016. Total premiums ceded under the 2017 risk transfer program were $93 million, representing a decrease from 2016 of $88 million (47%). The year-over-year decrease in premiums ceded resulted from decreases in total coverage purchased, driven by reductions in exposure within the Coastal Account, in addition to favorable risk-adjusted reductions in pricing. The structure of the 2017 reinsurance program included a combination of traditional reinsurance markets and capital markets and provided participating coverage from an aggregate event 1-in-14 year PML (1-in-15 year single event) to an aggregate event 1-in-80 year PML (1-in-86 year single event) which approximated the attachment point of the 2016 reinsurance program but provided a lower exhaustion point relative to the 2016 reinsurance program that exhausted at an aggregate 1-in-121 year PML (1-in-130 year single event). Citizens' primary goals in placing its reinsurance program are to eliminate, or to maintain the elimination of, the risk of assessment at the 1-in-100 year PML and to expose no more than 60% of its surplus. In 2017, Citizens' anticipated exposing no more than 50% of its surplus within the Coastal Account, however, due to larger than expected decreases in total exposure, actual surplus exposed within the Coastal Account was approximately 40% prior to the landfall of Hurricane Irma. Coverage with the Florida Hurricane Catastrophe Fund (discussed below) inures to the benefit of participants on the traditional reinsurance program.

Citizens anticipates its 2018 reinsurance program structure to be similar to the 2017 reinsurance program, with a combination of single year and multi-year aggregate and per-occurrence coverage along with continued participation in the capital markets. Reinsurance premiums budgeted for 2018 are $100 million, however, the actual amount of ceded reinsurance premiums in 2018 may differ due to the final layers of coverage purchased.

Pursuant to its enabling statute, Citizens must participate in the Florida Hurricane Catastrophe Fund (FHCF), a statutorily-created reinsurance facility. While private carriers may elect among several coverage options (90%, 75%, 45%), Citizens is required to purchase coverage at the 90% coverage limit. Coverage through the FHCF is purchased for each of Citizens' three accounts (for purposes of the FHCF, the PLA and CLA are considered together as a single, separate participating insurer with its own exposures, reimbursement premium and loss reimbursement.), however, catastrophic losses incurred by Citizens on commercial non-residential policies (written only in the CLA and Coastal Account) are not covered by the FHCF. In 2017, the FHCF provided coverage totaling $2.3 billion, representing a decrease of approximately $400 million from 2016 (15%). Total premiums ceded to the FHCF during 2017 were $154 million, or $22 million (13%) less than the amount of premiums ceded during 2016. Because the FHCF has a limit of insurance defined by Florida Statute and because private carriers are able to select one of three coverage options, Citizens' share of the statewide limit is influenced both by its market share and by elections made by private carriers. Citizens' retention levels through the FHCF are affected by Citizens' market share only.

Citizens' risk transfer program, including its participation in the FHCF, does not relieve Citizens from its obligations to policyholders. Citizens remains liable to its policyholders for the portion reinsured to the extent that any reinsurer does not meet the obligations assumed under their reinsurance agreements.

ASSESSMENTS

Citizens' enabling legislation and the Plan establish a process by which Citizens is required to levy assessments to recover deficits incurred in a given plan year for any of its three accounts. Deficits are calculated separately, and assessments are accordingly levied separately, for each of the three accounts. The Plan provides for deficits to be determined based on Citizens' GAAP-basis total net position, adjusted for certain items. In the event of a Plan Year Deficit in any Account, Citizens must first levy an assessment against the premium of each Citizens policyholder (the Citizens Policyholder Surcharge) in each of Citizens' Accounts, as a uniform percentage of the premium of the policy of up to 15% of such premium. Citizens Policyholder Surcharges are not subject to commissions, fees, or premium taxes; however, failure to pay a Citizens Policyholder Surcharge will be treated as failure to pay premium. If the Citizens Policyholder Surcharge is insufficient to eliminate the deficit in an Account, Citizens would then levy a Regular Assessment on assessable insurers and assessable insureds. The Regular Assessment is applied as a uniform percentage of the premium of the policy up to 2% of such premium and is available to reduce or eliminate deficits in the Coastal Account only. Regular Assessments are levied on assessable insurers and insureds, as defined in Section 627.351(6), Florida Statutes, based upon each assessable insurer's or insured's share of direct written premium for the subject lines of business in the State of Florida for the calendar year preceding the year in which the deficit occurred. Regular Assessments on assessable insurers or insureds, collectively, are based on the ratio of the amount being assessed for the Coastal Account to the aggregate statewide direct written premiums for the subject lines of business for the preceding year. If the deficit in any year in any account is greater than the amount that may be recovered through Citizens Policyholder Surcharges and Regular Assessments (Coastal Account only), Citizens is required to levy any remaining Plan Year Deficit as an Emergency Assessment. An Emergency Assessment is to be collected by all assessable insurers, Surplus Lines Agents, and Citizens from policyholders upon the issuance or renewal of policies for Subject Lines of Business for as many years as necessary to cover the Plan Year Deficit in the account. The primary difference between the assessment base for Regular Assessments and Emergency Assessments is the inclusion of Citizens' direct written premium in the assessment base for Emergency Assessments. For purposes of Regular Assessments and Emergency Assessments, the Subject Lines of Business are all lines of property and casualty insurance, including automobile lines, but excluding accident and health, workers' compensation, and medical malpractice insurance, and also excluding insurance under the National Flood and Federal Crop insurance programs.

DEPOPULATION

Pursuant to the Act, Citizens is authorized to adopt one or more programs, subject to approval by the Office, to facilitate the reduction of both new and renewal writings. Policies may be removed from Citizens at policy renewal or as part of a bulk assumption (Assumption Agreement). For policies that are assumed as part of a bulk assumption, Citizens cedes 100% of the remaining unearned premium reserve at the date of assumption for policies that are assumed. In an assumption, the assuming insurer is responsible for losses occurring from the assumption date through the expiration of the Citizens' policy period (the assumption period). Subsequent to the assumption period, the assuming insurer will write the policy directly. In January 2007, Florida law was amended to state that assumed policies are the direct insurance of the assuming insurer, for the purpose of clarifying that FIGA is liable for assumption period losses occurring during the assumption period if an assuming insurer were liquidated and unable to meet its obligation to policyholders. Citizens provides policy administration services with respect to the assumed policies. All agreements provide for the assuming insurer to adjust losses. While Citizens is not liable to cover claims after the assumption, Citizens continues to service policies for items such as policyholder endorsements or cancellation refunds. Should Citizens process and provide a refund to policyholders, such amount is subsequently collected from the assuming insurer. During 2017, approximately $140 million in storm risk was removed through depopulation, marking a substantial decline relative to 2016 during which approximately $1 billion in storm risk was removed. The current litigation environment surrounding non-weather water claims, an active 2017 hurricane season and the anticipated impact to private market surplus, and the risk profile of Citizens' remaining policies have affected the private market's capacity to maintain its historically high-level of depopulation activity.

FINANCIAL POSITION

Citizens' financial position at December 31 is as follows (unaudited):

	December 31	
	2017	2016
	(in thousands)	
Admitted assets		
Bonds	$ 8,881,287	$ 10,815,093
Cash and short-term investments	1,227,756	1,290,512
Total cash and invested assets	10,109,043	12,105,605
Investment income due and accrued	68,958	75,183
Premiums receivable	72,053	75,615
Reinsurance recoverable on paid losses and LAE	887	1,143
Other receivables under reinsurance contracts	472	6,614
Assessment receivable	(151)	907
Other admitted assets	3,817	3,750
Total admitted assets	$ 10,255,079	$ 12,268,817
Liabilities and accumulated surplus		
Liabilities:		
Loss reserves	$ 740,371	$ 499,051
Loss adjustment expense reserves	432,163	221,765
Retroactive reinsurance ceded	(1,430)	(1,411)
Unearned premiums	430,586	440,413
Taxes and fees payable	(462)	(180)
Provision for reinsurance	17,281	11
Bonds payable	1,983,573	3,361,156
Interest payable	7,856	12,745
Advance premiums and suspended cash	21,814	24,244
Other liabilities	264,027	309,221
Total liabilities	3,895,779	4,867,015
Accumulated surplus:		
Restricted	8,243	8,237
Unrestricted	6,351,057	7,393,565
Total accumulated surplus	6,359,300	7,401,802
Total liabilities and accumulated surplus	$ 10,255,079	$ 12,268,817

Cash and invested assets

Citizens utilizes investment policies focused on principal preservation, competitive returns, and adequate liquidity in order to meet future claim obligations. Citizens' invested assets are governed by five investment policies, three for taxable operating funds and two for tax-exempt bond proceeds: 1) Liquidity Fund (Taxable) – generally this policy will govern the investment of funds and surplus that, in addition to internally managed cash, will be the first monies used to pay claims after an event, and that can be used to pay operating expenses on an ongoing basis; 2) Liquidity Fund (Tax-exempt) – generally this policy will govern the investment of tax-exempt pre-event bond proceeds and other monies required to be invested in tax-exempt instruments. Citizens will use these monies to pay claims after an event or to pay principal and / or interest payments on an as needed basis; 3) Claims-Paying Fund (Taxable) – generally this policy will govern the investment of funds that will be used to pay post-event claims after Citizens has expended all monies in the Liquidity Fund. Only monies eligible for investment in taxable instruments will be deposited in this fund; 4) Claims-Paying Fund (Tax-exempt) – generally this policy will govern the investment of tax-exempt pre-event bond proceeds and other monies required to be invested in tax-exempt instruments. Citizens will use these monies to pay claims after an event, typically after all funds in the Liquidity Fund have been expended; and 5) Claims-Paying Long Duration Fund (Taxable) – generally this policy will govern the investment of funds that will be used to pay post-event claims after Citizens has expended all monies in the Liquidity Fund and Claims-Paying Fund. During 2017, Citizens' instituted several changes to its investment policies in order to capitalize on market conditions and to provide additional diversification across the portfolios, the impact of which is to produce incremental increases in investment yields and reduce risk through diversification while maintaining principal preservation and liquidity. Changes instituted to Citizens' investment policies during 2017 were as follows:

Taxable funds:

- minimum ratings of Baa2 / BBB changed to average ratings of Baa2 / BBB, with no ratings below Baa3 / BBB-
- allow publicly issued asset-backed securities for equipment lease receivables with ratings of Aaa / AAA / AAA
- add a single issuer exposure limit of 0.75% of the portfolio for asset-backed securities
- increase asset-backed securities composition percentage from 5% to 7.5% (taxable claims-paying and taxable claims-paying long duration funds only)
- increase duration for the taxable claims-paying fund and taxable claims-paying long duration fund
  - from 20% to 25% for securities with final maturities between 85-121 months (taxable claims-paying fund)
  - from 20% to 25% for securities with final maturities between 12 years and 15 years 1 month (taxable claims-paying long duration fund)

Taxable Liquidity Fund:

- increase corporate floating rate note composition percentage from 35% to 50%

Taxable Claims-Paying Long Duration Fund:

- increase corporate composition from 70% to 75% and reduce Treasury / Agency composition from 30% to 25%

Citizens engages independent investment managers to invest bond proceeds and certain operating cash pursuant to its taxable and tax-exempt investment policies. Throughout the year and depending on the immediacy of liquidity needs, 80 to 90% of Citizens' total invested assets are managed by independent investment managers. Citizens' investment portfolio consists of high-quality investment grade debt instruments such as US Treasury and Agency securities and money market funds, corporate bonds, commercial paper and certificates of deposit, tax-exempt money market funds, taxable municipal bonds, tax-exempt municipal bonds, tax-exempt variable rate demand notes, and prime money market funds.

Declines in market value of invested assets are continually evaluated to determine whether these declines are temporary or other-than-temporary in nature. In making this determination, Citizens monitors external impairment indicators such as issuer credit ratings as well as the extent and length of the related declines and internal impairment indicators such as Citizens' intent and ability with respect to retention of the impaired securities. These indicators are obtained from both third-party valuation services and internal analyses performed by Citizens.

Cash and the carried value of Citizens' invested assets totaled approximately $10.1 billion at December 31, 2017, exhibiting a decrease of $2 billion from December 31, 2016. Of this decrease, approximately $585 million resulted from net cash used in operating activities driven by loss and LAE payments largely related to Hurricane Irma. In June 2017, approximately $1 billion of Citizens' senior secured pre-event bonds matured for its Series 2009A-1 (Coastal), Series 2010A-1 (Coastal) and Series 2012A-1 (PLA / CLA). In December 2017, Citizens' exercised an optional redemption of $350 million of outstanding Series 2015A senior secured pre-event bonds at par value. The exercised option included the redemption of $50 million of fixed rate Series 2015A-1 Senior Secured Bonds with original maturities of June 1, 2018 along with $300 million of SIFMA floating-rate Series 2015A-2 Senior Secured Bonds with original maturities of June 1, 2018 ($150 million) and June 1, 2020 ($150 million).

Year-over-year variances in net premiums collected, underwriting expenses paid and net investment income received did not contribute significantly to year-over-year changes in cash and invested assets.

In anticipation of short-term cash flow needs associated with Hurricane Irma, Citizens' increased its position in money market funds during the last quarter of 2017. At December 31, 2017, Citizens' position in money market funds was $1.1 billion whereas at December 31, 2016, $655.9 million was held in money market funds. Within the taxable portfolios, there was no substantial change in the composition of invested assets from 2016 to 2017. Within the tax-exempt portfolio, a smaller proportion of assets were held in US Government and Agency securities in 2017 compared to 2016, with an offsetting increase in municipal bonds. The change in invested asset composition in the tax-exempt portfolio was driven by decreases in bond sinking fund deposits that are invested in US Government and Agency securities for contractual maturities scheduled in the following fiscal year. Approximately $1 billion of senior secured pre-event bonds matured in June 2017 compared to anticipated maturities of $255 million in June 2018, thereby reducing the year-end balances in bond sinking funds.

Average duration across all portfolios was 2.94 at December 31, 2016 compared to 4.07 at December 31, 2017. Average duration within the tax-exempt portfolio and taxable claims and liquidity portfolios were relatively unchanged from 2016 to 2017. The taxable claims-paying long duration fund that was added in 2017 had an average duration of 5.6 and comprised approximately 49% of invested assets at December 31, 2017, causing a year-over-year increase in average duration in invested assets.

Average credit quality at December 31, was as follows:

Taxable Portfolios	2017	2016
AAA	16%	6%
AA	40%	45%
A	28%	34%
BBB	15%	14%
BB	0%	0%
A-1 Short Term	1%	1%
Legacy Securities	1%	1%

Tax-Exempt Portfolio	2017	2016
AAA	28%	24%
AA	58%	57%
A	13%	17%
BBB	0%	1%
A-1 Short Term	0%	0%

The increase in AAA positions within the taxable portfolios was driven by an increase in assets held in money market funds. Similarly, the increase in AAA positions within the tax-exempt portfolio was driven by an increase in municipal bond holdings due to reductions in bond sinking fund balances as discussed above.

Citizens' investment holdings remain well-positioned heading into 2018 during which additional rate increases by the Federal Reserve are highly likely. Continued economic growth is expected to add modest increases in book value to Citizens' existing investments, while overall increases to the short-end of the yield curve will provide opportunity for reinvestment at more attractive rates. Furthermore, volatility in credit spreads are expected to produce short-term fluctuations in pricing that may allow Citizens' to reposition portfolio holdings to capture realized gains.

Other receivables under reinsurance contracts

Other receivables under reinsurance contracts consist of amounts due from assuming insurers for policies assumed through depopulation. Receivables arise as a result of cancellations and premium-bearing endorsements to policies assumed by assuming insurers but for which Citizens is continuing to provide policy administration services. During 2017, and as further discussed on page 9, a substantial decrease in policy assumption activity was observed, most notably during November and December of 2017, leading to a decrease in amounts due from assuming insurers

Assessment receivable

During 2017, assessment collections related to the Florida Insurance Guaranty Association (FIGA) were completed, leading to a marginal excess in assessment amounts collected. Citizens expects to remit the collections to FIGA during the first half of 2018.

Reserve for losses and loss adjustment expenses

Reserves for unpaid losses and loss adjustment expenses (LAE) are stated at Citizens' estimate of the ultimate cost of settling all incurred but unpaid claims. Incurred losses and LAE represent a combination of payments for loss and LAE as well as changes in reserves that occur during the calendar year. Activity with respect to reserves for unpaid losses and LAE for the years ended December 31, 2017 and 2016 were as follows (*in thousands*) (unaudited):

	2017	2016
Balance at beginning of year	$ 720,816	$ 732,612
Incurred related to:		
Current accident year	1,526,417	426,236
Prior accident years	38,677	86,678
	1,565,094	512,914
Paid related to:		
Current accident year	796,179	157,912
Prior accident years	317,196	366,798
	1,113,375	524,710
Balance at end of year	$ 1,172,535	$ 720,816

	2017	2016
	(in thousands)	
Losses / LAE incurred - catastrophe	1,159,488	$ 38,968
Losses / LAE incurred - non-catastrophe	405,606	473,946
Total losses incurred	$ 1,565,094	$ 512,914

Reserves for unpaid losses, net of amounts ceded under reinsurance contracts, increased $241 million (48%) and reserves for unpaid LAE reserves, net of amounts ceded under reinsurance contracts, increased $210 million (95%). Net unpaid losses and LAE reserves related to catastrophes (2004 and 2005 hurricanes, 2008 Tropical Storm Fay, 2016 Hurricanes Hermine and Matthew, and 2017 Hurricane Irma) increased $499 million as a result of 2017 hurricane losses. Net unpaid losses and LAE reserves not related to hurricanes decreased $48 million due to modest reductions in the number of policies in force and settlement of reserve balances from prior years. Additional analysis and discussion of current year loss and LAE activity is included, beginning on page 8, within the Results of Operations section.

Provision for reinsurance

At December 31, 2017, Citizens' recognized a provision for reinsurance of $17 million for unsecured amounts due from unauthorized reinsurers. Substantially all unsecured amounts due are ceded IBNR reserves related to ceded losses and LAE from Hurricane Irma. Management expects that all amounts due to Citizens will be collected.

Bonds payable

Citizens has issued multiple Senior Secured Bonds for the purpose of funding losses in the event of a future catastrophe to ensure that liquidity demands associated with policyholder obligations can be met. These bonds are secured by pledged revenues which consist of monies and investments held in accounts established under the trust indenture, proceeds from any surcharges, regular and emergency assessments, and/or reimbursements received from the FHCF. During 2017, cash outflows associated with Citizens' Senior Secured Bonds totaled $1.3 billion in principal repayments, of which $350 million was associated with the optional bond redemption in December 2017. During 2017 and 2016, Citizens paid $127 million and $176 million, respectively, in debt service payments.

<u>Other liabilities</u>

Effective July 1, 2015, Citizens terminated the 2005 HRA Emergency Assessment that was activated as a result of unprecedented storm activity during 2004 and 2005 during which eight hurricanes made landfall in various southern US states, including Florida. The collection of these assessment funds were used for debt service obligations incurred in connection with the now defeased 2007A post-event bonds that were issued to provide claims paying resources to Citizens. Amounts collected by Citizens in excess of the 2005 HRA Emergency Assessment levy are held in a reserve account and may be used by Citizens to offset future plan year deficits as approved by the Board and Office. At December 31, 2017, funds held in this reserve totaled $144 million. Other liabilities also include amounts payable to reinsurers for premiums ceded under the 2017 risk transfer program and amounts payable for premiums ceded through depopulation. At December 31, 2017, ceded premiums payable totaled $51 million, approximately $42 million less than at December 31, 2016.

RESULTS OF OPERATIONS

Operating results and policies in force for 2017 and 2016 were as follows (unaudited):

	Years Ended December 31	
	2017	**2016**
	(in thousands)	
Premiums earned	$ 626,446	$ 625,540
Losses incurred	1,032,852	345,768
Loss adjustment expenses incurred	532,242	167,146
Other underwriting expenses incurred	226,317	241,460
Underwriting loss	(1,164,965)	(128,834)
Net interest income	207,968	171,082
Net realized gain on sales	18,430	66,195
Interest expense	(94,243)	(137,928)
Net investment income	132,155	99,349
Other income	4,427	2,407
Net (loss)	$ (1,028,383)	$ (27,078)
Policies in force	440,406	455,843
Policies serviced	463,754	500,071

<u>Underwriting loss</u>

During 2017, Citizens incurred an underwriting loss of $1.2 billion representing a significant increase relative to 2016. The current year underwriting loss was dominated by $1.2 billion in net losses and LAE incurred related to Hurricane Irma as well as loss and LAE costs associated with higher levels of litigated non-weather water losses. Reductions in year-over-year costs of Citizens' risk transfer program along with declines in underwriting expenses partially offset net underwriting costs related to non-catastrophe loss and LAE activity.

Direct Written Premium

During 2017, consolidated direct written premium decreased $80 million (8%). By account, increase or decreases in direct written premium were $25 million (5%), -$17 million (-47%), and -$87million (-19%) within the PLA, CLA, and Coastal Account, respectively.

In July 2017, Citizens launched voluntary contractor network programs, allowing policyholders the option of using these programs for water mitigation services and / or permanent repairs. The water mitigation services are not subject to policy deductibles or the $3,000 / 1% policy coverage threshold. In 2017, Citizens also proposed further changes to address the continuing issues with AOB, litigation and claim costs, including a $10,000 sub-limit for non-weather water losses. Policyholders who choose the option of using Citizens' Managed Repair Program (MRP) shall not be subject to the $10,000 sub-limit. Policy changes are also being introduced to extend relevant duties required of the policyholder to apply to any claimant who receives policy benefits. These changes are under development for a 2018 launch. Additionally, underwriting rules were updated to improve the quality of home inspections to identify potential issues that can result in claims and to better address policies with multiple water losses.

In 2017, Personal Lines Underwriting continued to refine its automated underwriting processes to reduce time, cost, and potential bottlenecks associated with manually processing policy applications and forms. In October 2017, the percentage of personal lines policies experiencing some level of automation reached 100%. In December 2017, Commercial Underwriting completed its Renewal Underwriting Initiative (RUI), reviewing the accuracy of key data and rating elements on over 30,000 individual commercial buildings. Personal Lines Underwriting began a rigorous Data Quality Review (DQR) initiative in 2017, reviewing over 11,000 DP-3D policies prior to their renewal.

Through 2018, Personal Lines Underwriting will continue the DQR initiative. Additionally, Underwriting (Personal Lines and Commercial Lines) will continue compliance requirements associated with the OIR's Hurricane Irma Emergency Order while continuing response efforts related to the storm's impact. This includes addressing the necessary repairs required for several thousand structures to remain eligible for coverage with Citizens.

An analysis of observed trends in direct written premium, by account, follows:

Personal Lines Account

At December 31, 2017, the number of policies inforce within the PLA was approximately 300,000 reflecting a 2.5% increase relative to December 31, 2016. While the number of cancellations and non-renewals as well as new policies decreased modestly during 2017, the number of policies assumed decreased substantially. For the year ended December 31, 2017, total premiums ceded through depopulation were $9 million compared to $19 million during 2016. While the number of policies inforce increased 2.5%, premiums written increased 5.5%.

Commercial Lines Account

At December 31, 2017, the number of policies inforce within the CLA was approximately 1,300 reflecting a 31% decrease relative to December 31, 2016. The number of new policies written during 2017 was 25, less than half the amount of new policies written during 2016. The number of cancellations (151) and non-renewals (371) contributed most significantly to the year-over-year decrease in policies inforce. Premiums written during 2017 decreased 47% from $37 million to $20 million. Citizens' commercial policies remain attractive to insurers both in the private market and E&S market, particularly commercial policies with higher average premiums, leading to decreases in premiums written surpassing decreases in policies inforce. Ceded premiums through depopulation during 2017 were $176,000 or $1.4 million (89%) less than 2016.

Coastal Account

At December 31, 2017, the number of policies inforce within the Coastal Account was approximately 139,000 reflecting a 14% decrease relative to December 31, 2016. Although policies assumed during 2017 were approximately half the amount assumed during 2016, the number of non-renewals and cancellations outpaced the number of new policies written causing year-over-year declines in policies inforce. For the year ended December 31, 2017, total premiums ceded through depopulation were $22 million compared to $42 million during 2016. Premiums written during 2017 decreased 19% from $466 million to $379 million.

Across all accounts and lines of business, the 2017 rate filings (effective May 2018) are expected to produce approximate rate increases ranging from 0.9% to 10.1% depending on the segment of business.

Losses and LAE incurred

During 2017, Citizens' net loss and net LAE ratios increased significantly as a result of the impact of Hurricane Irma. For calendar year 2017, Citizens' net loss ratio was 165%, an increase of 110%, while the net LAE ratio was 85%, an increase of 58%. Hurricane Irma contributed 126% to the net loss ratio and 59% to the net LAE ratio for calendar year 2017.

An analysis of direct loss and LAE activity, by account, follows:

Personal Lines Account

	Non-CAT	CAT	Total
Direct Loss Ratio			
Prior Accident Years	*2.4%*	*0.1%*	*2.4%*
Accident Year 2017	*41.5%*	*115.5%*	*157.0%*
Calendar Year 2017	43.8%	115.5%	159.4%
Direct LAE Ratio			
Prior Accident Years	*1.4%*	*0.3%*	*1.7%*
Accident Year 2017	*24.8%*	*47.9%*	*72.7%*
Calendar Year 2017	26.2%	48.2%	74.4%

For the year ended December 31, 2017 the direct non-catastrophe loss and LAE ratio within the PLA declined 7.6% to 70%. During the 4th quarter of 2016, adverse reserve development on accident year 2015 contributed more than 15% to the 2016 calendar loss ratio as a result of an increase in the number of non-weather water claims entering litigation. During the 4th quarter of 2017, a noticeable decline in the number of litigated claims was observed leading to a modest level of favorable reserve development on prior accident years. However, considerable uncertainty remains as to whether or not this decline is the result of a temporary suspension in litigation activity due to Hurricane Irma or suggestive of a new trend. Despite favorable reserve development due to a reduction in 4th quarter litigated claims, adverse reserve development was recognized on prior accident years for sinkhole claims. Sinkhole claims that predate Senate Bill 408 that are in settlement are continuing to close as anticipated, however, claims that are not in settlement have experienced adverse development.

Hurricane Irma contributed approximately 163% ($756.4 million) to the 2017 direct loss and LAE ratio. At December 31, 2017, approximately 38,000 claims were reported for the PLA and approximately 41,500 claims are projected in total. Litigation activity for Hurricane Irma claims is considered in the reserve estimate; it is anticipated that close to 30% of all personal lines claims will enter litigation. The severity for litigated claims is assumed to be considerably higher than for non-litigated claims for loss and LAE. Approximately $193 million in ceded loss and LAE reserves have been recognized at year-end.

Commercial Lines Account

	Non-CAT	CAT	Total
Direct Loss Ratio			
Prior Accident Years	*-6.5%*	*0.0%*	*-6.5%*
Accident Year 2017	*9.8%*	*72.5%*	*82.3%*
Calendar Year 2017	3.3%	72.5%	75.8%
Direct LAE Ratio			
Prior Accident Years	*-3.8%*	*0.1%*	*-3.6%*
Accident Year 2017	*1.5%*	*14.0%*	*15.6%*
Calendar Year 2017	-2.2%	14.2%	11.9%

The diminishing relative size continues to leave CLA loss and LAE results very susceptible to adjustments in prior accident year loss and LAE reserves that are dominated by several large claims.

The largest source of risk within the CLA is pending sinkhole claims from prior accident years. At December 31, 2017, approximately $20 million and $30 million are recorded for case reserves and IBNR, respectively, for the roughly 250 pending sinkhole claims. As these sinkhole claims continue to settle, additional volatility in the calendar year loss and LAE ratios is anticipated in future periods.

Hurricane Irma contributed approximately 87% ($22.2 million) to the 2017 direct loss and LAE ratio. At December 31, 2017, approximately 230 claims were reported for the CLA and approximately 250 claims are projected in total. Approximately $6 million in ceded loss and LAE reserves have been recognized at year-end.

Coastal Account

	Non-CAT	**CAT**	**Total**
Direct Loss Ratio			
Prior Accident Years	*-0.1%*	*0.0%*	*-0.1%*
Accident Year 2017	*11.3%*	*218.0%*	*229.3%*
Calendar Year 2017	11.2%	218.0%	229.2%
Direct LAE Ratio			
Prior Accident Years	*0.9%*	*0.3%*	*1.2%*
Accident Year 2017	*10.7%*	*50.4%*	*61.1%*
Calendar Year 2017	11.6%	50.7%	62.3%

During 2017, the Coastal Account did not experience any meaningful reserve development (favorable or adverse) nor were there any significant variances between the 2017 and 2016 accident year loss ratios. The 2017 accident year LAE ratio increased approximately 3% relative to 2016 as a result of an increase in LAE severity.

Hurricane Irma contributed approximately 268% ($1,032.4 million) to the 2017 direct loss and LAE ratio. At December 31, 2017, approximately 25,800 claims were reported for the Coastal Account and approximately 29,000 claims are projected in total. Approximately 30% of personal lines claims within the Coastal Account are expected to enter litigation, consistent with the same indemnity and LAE severity as the PLA. Approximately $461 million in ceded loss and LAE reserves have been recognized at year-end.

Net investment (expense) income

Net investment income consists of interest earned on Citizens' invested assets, net realized gains on sales of invested assets, and interest expense incurred on senior secured bonds outstanding. During the first and second quarters of 2017, certain positions in invested assets were liquidated in order to fund portfolios managed against the taxable claims-paying long duration investment policy. While this liquidation resulted in an increase in year-over-year realized losses, a majority of these losses were offset by increases in earned income. Net realized gains in 2017 and 2016 were $18 million and $66 million, respectively. During 2017, earned income was $213 million, marking a significant increase of $36 million (20%) relative to 2016. The increase in earned income was primarily driven by an increase in holdings within the taxable claims-paying long duration fund that held approximately 49% of total invested assets at December 31, 2017. Interest expense incurred on senior secured bonds outstanding were $94 million during 2017 in comparison to $138 million in 2016. Bond maturities that occurred in June 2017 as well as the optional bond redemption exercised in December of 2017 led to the reduction in year-over-year interest expense.

CASH FLOW AND LIQUIDITY

Cash flows for the years ended December 31 are as follows (unaudited):

	Years Ended December 31	
	2017	**2016**
	(in thousands)	
Operating activities		
Premiums collected, net of reinsurance	$ 578,405	$ 545,301
Loss and loss adjustment expenses paid	(1,114,537)	(523,247)
Underwriting expenses paid	(217,848)	(236,728)
Net investment income received	164,486	106,690
Other income (expenses) received (paid)	4,931	(2,525)
Net cash used in operating activities	(584,563)	(110,509)
Investing activities		
Proceeds from investments sold, matured or repaid	7,361,552	8,830,342
Investments acquired	(5,488,954)	(8,168,408)
Net cash provided by investing activities	1,872,598	661,934
Financing and miscellaneous activities		
Borrowed funds repaid	(1,348,500)	(923,085)
Other cash disbursed	(2,291)	(3,053)
Net cash used in financing and miscellaneous activities	(1,350,791)	(926,138)
Net decrease in cash and short-term investments	(62,756)	(374,713)
Cash and short-term investments:		
Beginning of year	1,290,512	1,665,225
End of year	$ 1,227,756	$ 1,290,512

The year-over-year increase in net cash used in operating activities was caused by loss and LAE payments associated with Hurricane Irma, despite moderate decreases in underwriting expenses paid and increases in net investment income collected. Net cash provided by investing activities increased largely as a result of liquidity needs stemming from claim obligations for Hurricane Irma as well as the June 2017 bond maturities and December 2017 optional bond redemption. Cash used in financing activities generally results from net cash flow activity related to Citizens' Senior Secured Bonds. As a statutorily-created insurer, the availability and adequacy of claims-paying resources are of paramount importance to Citizens' liquidity strategy. In determining its claims-paying resources, Citizens measures total resources, consisting of surplus, pre-event bond proceeds, coverage acquired through risk transfer, and coverage provided by the FHCF, against its modeled 1-in-100 year probable maximum loss (PML) plus 10% for LAE. For the 2017 hurricane season, Citizens' combined ratio of claims-paying resources to PML was 2.18, denoting that Citizens held available claims-paying resources of $2.18 per $1.00 of losses incurred at the 1-in-100 year PML plus 10% for LAE. Following Hurricane Irma, this ratio was 1.82, however, Citizens anticipates that following the 2018 renewal cycle of its reinsurance program that the combined ratio of claims-paying resources to PML will be approximately 2.00 depending on the final coverage placed. Citizens' risk transfer program for the 2018 storm season is expected to be finalized in May 2018.