Achieving Tax-Exempt Status and Efficiencies of Operation for Florida's Residual Market Property Insurers

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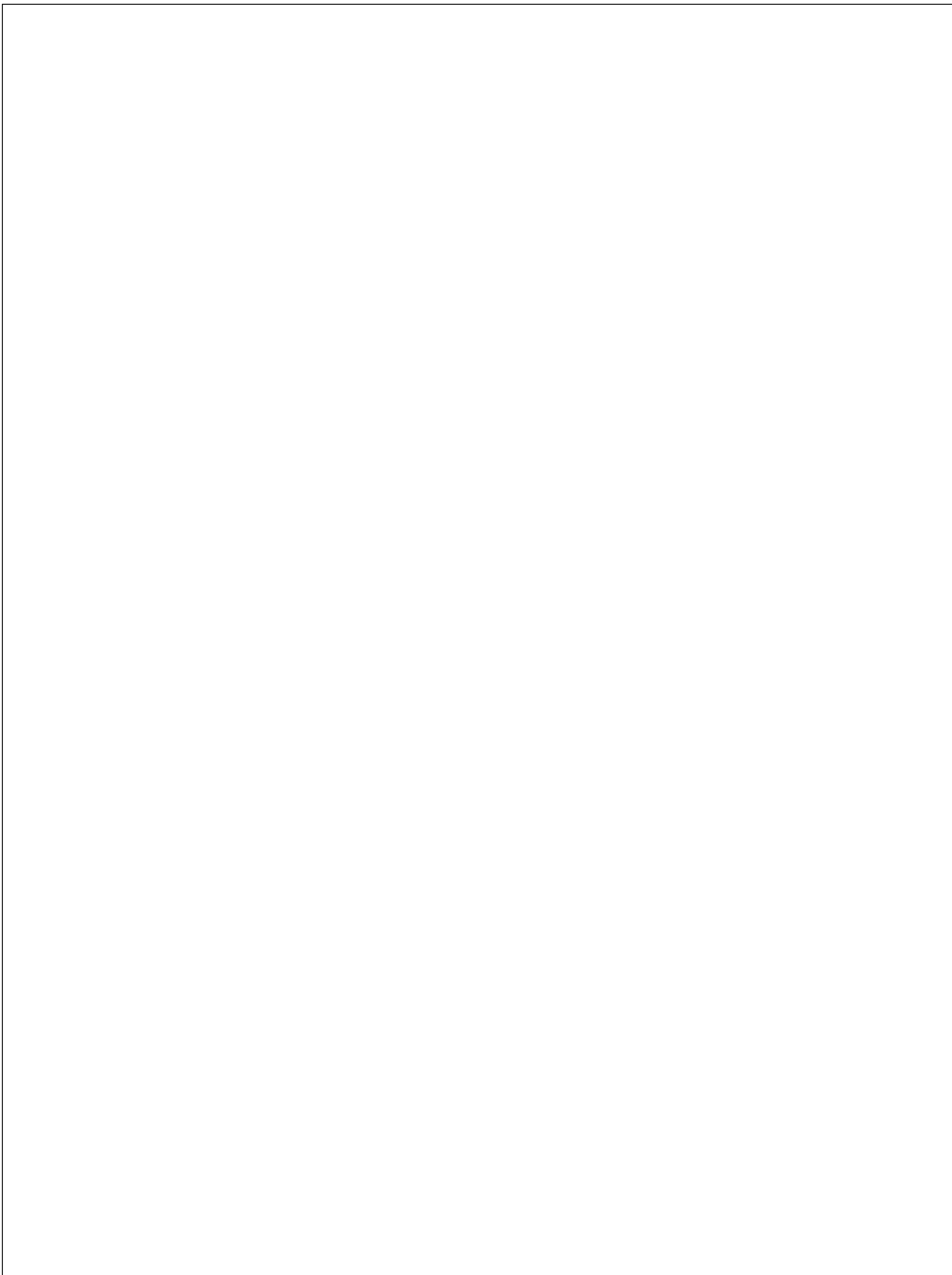

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Background

Florida law establishes two insurance entities to sell property insurance to persons unable to obtain coverage in the private market -- the Florida Windstorm Underwriting Association (FWUA) and the Florida Residential Property and Casualty Joint Underwriting Association (JUA). The FWUA was created in 1970 to sell windstorm coverage in designated coastal areas. After the market availability crisis caused by Hurricane Andrew in 1992, the JUA was created to sell full residential coverage statewide. Both insurance entities experienced tremendous growth, but the vast majority of policies in the JUA have now been taken out by private insurers. Currently, the FWUA has about 424,000 policies in force, while the JUA has been reduced from a peak of 937,000 policies to about 79,000 policies.

Funding hurricane losses for the FWUA and JUA has been a long-standing concern. The Florida Hurricane Catastrophe Fund will reimburse both entities for a portion of their hurricane losses, but debt financing must be utilized to be repaid by assessing all property insurers and their policyholders throughout the state.

The Department of Insurance proposed legislation in 2001, which was not enacted, to merge the FWUA and JUA into a single entity, named the Citizens Property Insurance Corporation (CPIC). A previous legislative working group in 1996 had recommended against merger of the two entities at that time, but recommended eventual consolidation after the JUA had been reduced to less than 100,000 policies. The department proposal was designed to achieve tax-exempt status for CPIC and to enable it to issue tax-exempt financing. Meanwhile, the JUA has filed a lawsuit in federal court seeking tax-exempt status and the FWUA and JUA are jointly pursuing federal legislation filed by Florida and Texas legislators that would classify the entities as tax-exempt.

Critics of the department proposal argue that the current residual market system is working relatively well and that little would be gained by merging the two entities at the expense of significant disruption and potentially jeopardizing outstanding debt obligations. It is also argued that the issues regarding the tax status are not directly related to merger of the associations and can be addressed separately, if necessary.

This report examines the current status of the JUA and the FWUA, the arguments for and against merger of the two entities, their current operating costs, and the potential for cost savings. The report then analyzes the legal issues and factors affecting the tax-status of the FWUA and JUA, including their current independent efforts to obtain tax-exempt status. The specifics of the department proposal are analyzed, followed by conclusions and recommendations.

Methodology

The report has gathered financial and status reports from the FWUA and JUA and legal memoranda regarding the tax-status of the entities, including documents filed by the JUA with the Internal Revenue Service (IRS) seeking tax-exempt status and the complaint filed in federal district court seeking tax refunds. The proposed legislation from the Department of Insurance has been analyzed including legal memoranda regarding its potential for obtaining tax-exempt status. Also reviewed are prior IRS private letter rulings that are available, documentation leading to the IRS opinion classifying the Florida Hurricane Catastrophe Fund as tax-exempt and the IRS opinion that the Fund may issue tax-exempt securities. Also reviewed is the Florida Supreme Court opinion regarding whether JUA revenues are state revenues for purposes of the revenue cap provisions of the Florida Constitution.

Findings

Florida Windstorm Underwriting Association

The Florida Windstorm Underwriting Association (FWUA) is a state-created insurer, organized in 1970, that sells windstorm and hail coverage in eligible areas, which include the coastal areas of 29 of Florida's 35 coastal counties.[1] In 1998, the Legislature prohibited further expansion of the areas eligible for FWUA coverage.[2] Policyholders must obtain a separate policy from a private insurer to cover non-wind risks, such as fire, theft, and liability, and a separate flood policy under the federal flood program. The FWUA provides coverage to both residences and businesses. There is a nominal limit of $1 million coverage per risk, but this limit may be exceeded if adequate coverage cannot be obtained in the voluntary market.

The FWUA is governed by a 15-member board of directors made up of 12 representatives of its member insurance companies and trade associations chosen by its members, one consumer representative appointed by the Governor, one appointed by the Insurance Commissioner, and the department’s consumer advocate. The FWUA’s Plan of Operation is subject to approval by the Department of Insurance (“department”), which was adopted by the department by rule.[3]

As of July 31, 2001, the FWUA had 424,070 policies insuring over $95 billion of property value. About 65% of this exposure is in Dade, Broward, and Palm Beach Counties. A continuing challenge is balancing the interests of FWUA policyholders with those of non-FWUA policyholders who are subject to assessments to fund FWUA losses.

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[1] The legislation authorizing the FWUA is in s. 627.351(2), F.S.
[2] Ch. 98-173, L.O.F.
[3] Rule 4J-1.001, Fla. Admin. Code.

The premiums charged by the FWUA must be filed by the FWUA board with the department and are subject to the same rate filing procedures that apply to property insurers, generally. The law expresses legislative intent that FWUA rates “not be competitive with the voluntary market” and requires rates be “reflective of department-approved hurricane rates in the voluntary market.”

All authorized Florida property insurers are subject to assessments to fund FWUA deficits, based on their market share. Small companies with less than $20 million in surplus writing 25% of their premiums on Florida property are exempt from assessments for losses above $50 million. Regular assessments against member insurers in a given year for losses in that year cannot exceed the greater of 10% of the FWUA deficit or 10% of the prior year’s statewide direct written premium. If that is insufficient, emergency assessments can be imposed as direct surcharges on policyholders, limited to these same percentages, after adding expenses associated with debt financing. Emergency assessments continue until the deficit is paid or until repayment in full of any debt issued to finance the deficit. Even a minor hurricane is likely to trigger regular assessments against property insurers, who may recoup these costs in higher premiums. A major hurricane would trigger multi-year emergency assessments on all property insurance policyholders.

The FWUA currently estimates that it faces a 1-in-100-year storm loss of $4.76 billion. This is the estimated loss from the single worst storm, referred to as the probable maximum loss (PML), that is likely over a 100-year period. Rating agencies typically require that insurers demonstrate their ability to pay claims for their 100-year PML. For 2001, the FWUA has only $70 million cash on hand and estimates it can collect $502 million in regular assessments against insurers. It is also entitled to collect up to $2.47 billion in estimated payments from the Florida Hurricane Catastrophe Fund (FHCF), the state reinsurance fund from which all property insurers must purchase coverage for a portion of their residential hurricane losses. However, the amount collectible from the FHCF is not triggered until the FWUA pays the first $705 million in losses, plus the FWUA must pay another $275 million (10% co-pay) of the layer of losses reimbursed by the FHCF. Funding for these amounts and excess losses is provided by assessments on insurers and debt financing supported by emergency assessments on policyholders.

The FWUA has already obtained debt financing by issuing $1.75 billion in “pre-event notes” in 1997 ($750 million) and 1999 ($1.0 billion) in order to have funds to promptly pay claims after a hurricane and to reduce the time and expense of post-event financing. These notes have maturity dates ranging from 2002 to 2019, for which the FWUA is paying an average interest rate of 6.92 percent, using premium and investment income, but the notes are secured by emergency assessments. (The FWUA has set aside funds from its income to retire $300 million of notes due in August 2002. At that time, subject to payment of any

hurricane claims, the $300 million will be converted to cash on hand to the FWUA.) The pre-event notes provide the FWUA with total resources of about $4.8 billion, which covers its estimated 100-year storm loss. An additional $750 million is available from a line of credit obtained by the FWUA for 2001, also funded by emergency assessments, if used. The resources available to pay each level of FWUA losses are shown on the chart, below.

FWUA 2001 CLAIMS PAYING RESOURCES

$ LOSS		
5.604 Billion	**POST-EVENT BONDS $(?)** Source: Emergency Assessments Levied Statewide on Property Policies	
4.854 Billion	**LINE OF CREDIT** $750 Million Source: Emergency Assessments Levied Statewide on Property Policies	
3.452 Billion	**PRE-EVENT NOTES** $1.402 Billion Source: Premium Revenue and Emergency Assessments	
705 Million	**FWUA RETENTION** (10%) Pre-Event Notes $275 Million	**FLA. HUR. CAT. FUND RECOVERY** (90%) $2.472 Billion (Residential Claims Only) Source: (i) FHCF Surplus (ii) Assessments on Property & Casualty Companies
632 Million	**PRE-EVENT NOTES** $73 Million Source: Premium Revenue and Emergency Assessments	
572 Million	**MARKET EQUALIZATION SURCHARGE** $60 Million Source: Recoupment from FWUA and JUA Policyholders	
70 Million	**REGULAR ASSESSMENT** $502 Million (Est.) Source: Assessment on Property Insurers; Recoupment from Policyholders	
	CASH ON HAND **$70 Million**	

Source: FWUA

The FWUA had only 62,000 policies prior to Hurricane Andrew in 1992. It then grew rapidly until 1998 when it reached a peak of 499,711 policies, after which its policy count decreased each year to its 7/31/01 total of 424,070, due to take-outs by three insurers, discussed below. However, the FWUA's current in-force liability of $95.5 billion is at an all-time high, meaning that the total insured property value has increased despite the drop in policies. (See chart below.)

FWUA Growth Since Hurricane Andrew

Year-end	In Force Policies	In Force Liability
1992	61,793	$7.5 billion
1993	115,588	15.3 billion
1994	184,010	27.0 billion
1995	229,548	36.3 billion
1996	282,824	49.5 billion
1997	417,342	75.4 billion
1998	499,711	91.1 billion
1999	465,008	90.3 billion
2000	431,784	92.6 billion
7/31/2001	424,070	95.1 billion

To encourage insurers to write windstorm coverage in FWUA-eligible areas (since its inception), the FWUA provides insurers with a credit against assessments based on their voluntary writings in FWUA areas. To further "depopulate" the FWUA, due to the increased threat of assessments caused by the policy growth after Hurricane Andrew, the 1997 Legislature provided that a FWUA policyholder is not eligible to continue coverage if an authorized insurer offers to provide windstorm coverage at its approved rates. Due mainly to concerns raised by the Department of Insurance, implementation of this law was delayed until take-out procedures were approved by the department on January 1, 2001. One complicating matter is that unlike the JUA, persons who have FWUA coverage also have a separate policy covering non-wind risks. If a take-out company offers full coverage, the FWUA policyholder must also cancel their non-wind coverage to avoid double coverage.

In 1999, the department approved plans for two insurers to take policies out of both the JUA and FWUA, which included payment by the JUA of cash bonuses to the two insurers. The current JUA law allows for payment of take-out bonuses to insurers, but the FWUA law does not. However, the department and the JUA board linked the payment of an enhanced JUA bonus to taking a minimum number of FWUA policies as well. Under these two take-out plans, Clarendon National Insurance company assumed over 37,000 FWUA policies and Qualsure Insurance Corp. assumed about 40,000 FWUA policies. Earlier this year, Tampa-based Atlantic Preferred Insurance Company offered to write over 58,000 FWUA policies, representing the first company to take FWUA policies without payment of JUA take-out bonuses. This prompted agents and insurers, particularly those writing the non-wind coverage on an affected policy to contact their policyholders in an effort to retain customers. In fact, most of the 58,000 policies have been provided coverage with private insurers other than Atlantic Preferred. Reportedly, other insurers have expressed interest to take-out FWUA policies.

An administrative lawsuit was brought by insurance agent associations against the FWUA and the Department of Insurance claiming that the FWUA's take-out procedures were not adopted in accordance with the Administrative Procedure Act. The FWUA had filed their procedures in the form of a manual with the department (after years of revisions and department input), which were approved by the department similar to the procedure used for approving rate or form filings of an insurer. On August 21, 2001 (shortly before publication of this report), a final order was issued by an administrative law judge finding that FWUA is a state agency for purposes of chapter 120, F.S., the Administrative Procedure Act, and that the take-out procedures are rules that were not adopted in accordance with, and therefore violate, section 120.54, F.S. The FWUA has filed a notice of appeal with the First District Court of Appeals.

Florida Residential Property and Casualty Joint Underwriting Association

The Florida Residential Property and Casualty Joint Underwriting Association (JUA) was created after Hurricane Andrew in 1992 to provide residential property insurance coverage statewide to persons unable to obtain private coverage.[4] At that time, Florida's property insurers were taking unprecedented actions in canceling policies and reducing their hurricane exposure in the state. The JUA surged to a peak of about 937,000 policies in 1996. Since then, authorized insurers have written hundreds of thousands of these policies under take-out plans approved by the Department of Insurance, spurred by cash incentives ("take-out bonuses") ranging from $100 to $300 per policy. As provided in the FWUA law, if an authorized insurer offers to write coverage for a residence insured by the JUA, the risk is no longer eligible for coverage in the JUA.

As of July 31, 2001, the JUA had 79,383 policies, insuring $12.7 billion in property value. Ninety-eight percent of the policies are in the three counties of Dade, Broward, and Palm Beach. The JUA reached is lowest number of policies in April 2000, when it had 59,628 policies, but it has averaged about 1,300 net new policies per month since that time, reaching its current total. The average has increased to about 2,600 new policies per month during the last 4 months (April-July 2001), which may be impacted by the repeal on June 1, 2001of the "moratorium" which limited the number of residential policies that an insurer could non-renew to reduce its hurricane exposure.[5]

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[4] Chapter 92-345, L.O.F.; the legislation authorizing the JUA is in s. 627.351(2), F.S.
[5] The "moratorium completion" provisions of ss. 627.7013(2) and 627.7014(2), F.S., were repealed on June 1, 2001, pursuant to ss. 627.7013(2)(e) and 627.7014(2)(d), F.S. Legislation was filed in the 2001 Regular Session, but not enacted, to continue these provisions. The June 1, 2001, repeal was scheduled in the 1998 law that extended the moratorium for 3 years (ch. 98-173, L.O.F.). The law applied only to policies in effect on June 1, 1996, limiting the percentage of residential policies that could be non-renewed

The JUA is generally provided the same assessment authority as described for the FWUA. However, the JUA has two accounts, one for personal lines residential risks and one for commercial residential risks. The premiums charged by the JUA are required to be the highest premiums in the county, compared to the top 20 insurers in the state by premium volume.

The JUA estimates its exposure to a 1-in-100-year storm to be $954 million. The resources available to pay JUA claims for the 2001 season are provided in the following order: (1) $150 million cash on hand (surplus); (2) $34 million in private reinsurance; (3) $325 million reimbursement from the Florida Hurricane Catastrophe Fund; (4) $400 million in regular assessments against insurers; (4) $500 million in pre-event notes (issued in 1997), secured by emergency assessments; and (5) a $570 million line of credit obtained for 2001, secured by emergency assessments. This totals $1.98 billion in claims-paying capacity for the 2001 hurricane season, nearly as great as the JUA's exposure to a 1-in-500-year storm loss, estimated at $2.19 billion.

Beginning August 1, 2001, the JUA began transferring $12.5 million each month to a "sinking fund" for 12 months, to pay off the $150 million note issue that matures in August 2002. This will decrease borrowing capacity for the 2001 hurricane season. A difference between the repayment methods used by the JUA and the FWUA, is that the JUA used the $150 million that they borrowed to pay off the debt and did not set up a defeasance account. Therefore, after the debt is paid, there will not be an additional $150 million added to surplus as "cash on hand." The FWUA, on the other hand, set up a defeasance account and funded it out of operating cash so that when their payment of $300 million is due in August of 2002, the defeasance account will be used to pay off the note, leaving the original $300 million still in their investment account and available as additional "cash on hand."

Merger of the JUA and FWUA -- What Would It Accomplish?

Recommendations of 1996 Legislative Working Group

The 1996 Legislature established a Legislative Working Group which was charged with recommending to the Legislature a permanent replacement for the FWUA and JUA.[6] However, the Working Group determined it was not practical

statewide and in any one county for purposes of avoiding hurricane coverage.

[6] Section 9 of ch. 96-194, L.O.F. The members of the Legislative Working Group on Residual Property Insurance Markets consisted of Senator John Grant, Co-Chairman,

to recommend a single replacement mechanism at that time and, instead, recommended that the two associations retain separate boards and work toward better coordination and eventual consolidation. It recommended that the boards develop a transitional plan for combining the two mechanisms into a single residual market, once the JUA reached 100,000 policies or met such other criteria as specified in the transition plan.[7]

At the time of the working group's deliberations, the JUA had grown to 930,000 policies, but an estimated 450,000 of these policies were identified to be taken out by private insurers. The FWUA, meanwhile, projected that it would nearly double in size to 456,000 policies by the end of 1998. The Working Group gave the following reasons for its conclusion that merger should be pursued, but delayed:

> *Because of the size of the JUA, anticipated swings in exposure for both the JUA and the FWUA in coming months, and a concern that regulatory stability and predictability be restored to the Florida market, the Working Group recommends that merging the two entities is not appropriate at this time.*
>
> *However, the Working Group does believe that the RPJCUA is a temporary residual market mechanism, and that both boards should work cooperatively toward eventual consolidation….*
>
> **…The boards should develop a transitional plan for combining the two mechanisms into a single residual market, once the JUA reaches 100,000 policies or meets such other criteria as specified in the transition plan.** [emphasis in original]
>
> *Restoration of a private market for insuring coastal hurricane risks throughout Florida may be years away, if ever a reality. Members of the Working Group believe that the unavailability of property insurance in noncoastal areas is mostly a temporary market aberration. Therefore, it should be the policy of the state to reduce the size of the JUA, toward the ultimate end of combining the two existing residual market entities. There may be a long-term need for residual property insurance other than coastal*

Rep. John Cosgrove, Co-Chairman, Senator Pat Thomas, Rep. Stan Bainter, Ms. Susanne Murphy, Deputy Insurance Commissioner, Mr. Steve Burgess, Insurance Consumer Advocate, Mr. Charles Boyd, representing domestic property insurers, Mr. Rick Brewer, representing mortgage lenders, Ms. Alita Dubour, representing consumers, Ms. Ann Wilkins Duncan, representing real estate agents, Ms. Jan Herard, representing consumers, Mr. Rade Musulin, representing domestic property insurers, Mr. Roy Pence representing home builders, and Mr. Thomas Rusche, representing property insurers.

[7] Final Report - Legislative Working Group on Residual Property Insurance Markets (December 13, 1996). A copy of this report is on file with the Senate Banking and Insurance Committee.

wind coverage, but once the private market has stabilized from the shock precipitated by Hurricane Andrew, the numbers of such policies should be very small.

The main benefits of a single entity would be better coordination of management and efficiency in operations. Because the FWUA and JUA boards have the best knowledge of how to effect the transition, they should develop the plan….

…The current legal structure of the JUA and FWUA should be retained, except that changes to achieve tax-exempt status should be considered, based on the advice of expert outside counsel. [emphasis in original] (Final Report - Legislative Working Group on Residual Property Insurance Markets, December 13, 1996)

The 1997 Legislature did not pursue merger of the FWUA and JUA but did require the two associations to create a joint coordinating council to assure that each association is informed of the activities of each other and to eliminate duplication of efforts.[8] Some of the other significant recommendations of the Working Group that were adopted into law included: (1) greater flexibility for the boards to determine eligibility for coverage; (2) providing that consumers who have been offered coverage by a private company not be eligible for coverage in the FWUA or JUA; (3) prohibiting any dividends or surplus funds from being distributed to member companies; and (4) providing that residual market rates should not fall below levels approved for the private market.[9]

Arguments for Merger

The general argument for merger of the JUA and FWUA is the lower administrative costs and greater efficiencies expected from having a single association, a single board, reduced total staff, one office location, fewer meetings and lower travel costs, reduced legal and lobbying fees, and other possible reductions in expenses. The costs associated with issuing bonds and other debt financing are also duplicated, to some extent, with two entities competing in the bond market, which may also increase the price of post-event bonds when these two associations, plus the Florida Hurricane Catastrophe Fund and, possibly, the Florida Insurance Guaranty Association, are seeking billions in debt financing.

Merger would also make it easier for the Legislature and regulators to apply consistent policy objectives to the residual market. Currently, the JUA and FWUA serve similar functions of being residual market property insurers, but there are significant differences with policy ramifications. The main difference is that the

[8] Section 627.3516, F.S. (Ch. 97-55, L.O.F.)
[9] Section 627.351 (Ch. 97-55, L.O.F.)

JUA provides full coverage statewide (subject to board-approved restrictions), and the FWUA provides windstorm coverage only in eligible areas. Also, the FWUA writes commercial, non-residential coverage, but the JUA does not. Amendments over the years have resulted in other important differences that reflect what appears to be inconsistent legislative policy. For example, the law: (1) provides for a majority of JUA board members to be appointed by the Insurance Commissioner, but provides for a majority of FWUA board members to be selected by insurers; (2) requires that JUA rates be the highest rates in the county compared to the top 20 insurers, but more generally requires that FWUA rates "not be competitive" with the voluntary market; (3) allows the JUA to pay take-out bonuses to insurers, but does not allow the FWUA to do so; (4) requires insurers taking policies out of the JUA to pay certain commissions to the previous agent, but does not require this for FWUA take-outs; (5) provides a different premium base for assessments for each association; and other differences.

There is no particular reason to have two state-created insurers writing property insurance, as recognized by the Legislative Working Group in 1996. The FWUA was expected to be a permanent entity, but the JUA was believed (or hoped) to be a temporary mechanism. The sharp reduction in JUA policies bears this out to some extent, but its remaining policies and recent growth indicates the need for a permanent residual insurer in the three-county, south Florida area. Also, the potential for another market crisis after the next catastrophe argues for the need to have a facility ready to issue statewide coverage. The FWUA, as currently structured, does not meet these needs, requiring either keeping the JUA as a permanent second facility or re-designing a single entity. Certainly, if the Legislature was starting from scratch, it would create one residual market property insurer, not two.

Arguments Against Merger

The contrary argument to merger is that little value or cost savings are likely to be gained at the expense of significant disruption to policyholders and potential adverse affects on financing. The current residual market system is working relatively well after years of adaptations, maintaining property insurance availability and obtaining adequate financing. It is not generally argued that either the JUA or FWUA, as separate entities, have excessive costs or are operating inefficiently. Both entities have obtained debt financing on what appears to be reasonable terms and it is critical that nothing be done to impair the obligations of the bonds they have issued. The credit worthiness of the existing associations and any replacement entity is essential to paying hurricane claims.

Merger does not in itself address many important policy concerns. For example, concerns about premiums are not more easily addressed by merger. Merger, in itself, is not likely to generate premium reductions. Premiums charged by a new

entity are likely to be required to be above, or non-competitive with, the private market as currently provided for the JUA or the FWUA. Any cost savings from increased efficiencies and reduced expenses are more likely to result in increased surplus, rather than premium reductions.

Other areas of concern can be addressed, without merger, such as the appropriate representation of board members and how such members are selected. Similarly, determining whether a new entity should write windstorm coverage, full coverage, or co-insure wind coverage, can be addressed under the current FWUA and JUA laws. The issue most discussed, the tax status of the residual market, can also be addressed for each entity, separately.

Tax-Exempt Status is Valuable But Not Directly Related to Merger

One of the most important issues, in terms of financial impact, is achieving tax-exempt status for the residual market. There are two separate tax issues: whether the income to the association is taxable, and whether the association is authorized to issue tax-exempt securities. Each of these issues is subject to different legal criteria, discussed below, and result in different savings.

If the income to the residual market is tax-exempt, savings would likely be in the tens of millions of dollars per year. The JUA paid income taxes in the amounts of $10.4 million for 1996, $88.3 million for 1997, $51.3 million for 1998, and $22.2 million for 1999. The FWUA paid income taxes in the amounts of $21.0 million for 1999 and $46.7 million for 2000.

If the association can issue tax-exempt securities, it would decrease the long-term cost of borrowing, potentially in the hundreds of millions of dollars. An analysis obtained by the department reflected that savings from tax-exempt financing, compared to taxable bonds, for a $2.5 billion bond issue would be about $401 million for 10-year bonds, $679 million for 15-year bonds, and $1.0 billion for 20-year bonds. For a $5 billion bond issue, the savings are estimated to be $802 million for 10-year bonds, $1.358 billion for 15-year bonds, and $2.0 billion for 20-year bonds.[10]

But, the issues affecting tax-status are not directly affected by merger of the two associations. Legislation deemed necessary to achieve tax exempt status for the income to the associations could be adopted separately for each association. It is also possible that tax-exempt status for the JUA may be achieved without state legislation if the JUA is successful in its current lawsuit against the federal government, discussed below. Tax-exempt status for both the FWUA and the

[10] Prepared by J.P. Morgan, reflecting market conditions as of February 28, 2001.

JUA may also be achieved through changes to the federal tax laws that is being actively pursued by the associations, also discussed below.

Further, the current law authorizes local governments to issue bonds in conjunction with the JUA or FWUA, payable from assessments, without pledging the taxing power of the local government, which bonds may be tax-exempt. These provisions are modeled on the law enacted in 1992 after Hurricane Andrew for the Florida Insurance Guaranty Association (FIGA) to obtain additional funding to pay claims of insolvent insurers. The law enabled FIGA to have $500 million of tax-exempt bonds issued through the city of Homestead, secured solely by a 2% FIGA assessment on property insurers, based on the legal opinion of bond counsel without obtaining a prior IRS ruling or opinion.[11]

However, a limitation on tax-exempt securities is that it is unlikely they can be authorized on a pre-event basis. It is the general consensus that tax-exempt securities for a residual market insurer could only be issued after a hurricane. At such a time, the bond market may have a limited capacity for tax-exempt securities, when the Florida Hurricane Catastrophe Fund and possibly the Florida Insurance Guaranty Association, would be competing for such investors. Also, the costs of post-hurricane bonds may be increased by the “headline risk” of bond investors being reluctant to buy securities associated with a state disaster secured by a de-stabilized insurance market. These factors tend to lessen the estimated cost-savings from non-taxable securities. It may be necessary to rely on taxable securities, and it may be prudent to obtain them on a pre-event basis when market conditions are deemed favorable, as both the JUA and FWUA have done.

Remaining Argument for Merger

Therefore, the argument for merger of the FWUA and JUA rests primarily on the grounds of lower administrative costs, increased efficiency of operations, and application of consistent policy goals by establishing a single, permanent facility to provide property insurance coverage when it is unavailable from private insurers. This may be an opportune time to implement a merger, given the relative stability of the market reflected by the level number of policies written in the residual market for the last few years and the low number of policies currently in the JUA. Merger was recommended by the 1996 Legislative Working Group at such time as the JUA fell below 100,000 policies, which has occurred. Also, if significant organizational changes to one or both organizations are deemed necessary for tax reasons or otherwise, the time may be right to implement a merger. But, great care must be taken not to impair outstanding debt obligations or the new entity’s ability to finance claims in the future. In addition, the Legislature must not only identify the factors affecting tax status, but also the possible

[11] Chapter 92-345, L.O.F.

unintended consequences of making such changes. Important decisions would still remain on premiums, coverage, and eligibility, which are not directly affected by either merger or tax-status factors.

The department has not estimated the cost savings expected to result from the merger of the FWUA and the JUA. Below, is a summary of the current operating costs of the two entities and an analysis of the potential for savings.

Operating Expenses of the FWUA and JUA and Potential for Cost Savings

The FWUA performs its policy issuance functions with in-house employees at its Jacksonville office, including receiving applications, underwriting, issuing policies, and making coverage changes. In contrast, the JUA contracts with insurance companies ("servicing carriers") and other entities to perform these functions. The JUA's staff in Tallahassee acts as a "home office," overseeing the work of these private contractors. Both entities use insurance agents who are paid commissions for selling policies and both entities contract with outside claims adjusters. They also both contract with outside legal counsel, accountants, and financial consultants.

The chart on the following page compares operating expenses of the JUA and the FWUA for 2000, in actual dollar amounts and as a percentage of written premium. The expenses shown do not include loss payments, claims adjustment expenses, reinsurance/Cat Fund premiums, line of credit fees or other financing costs, or JUA take-out bonuses.

Expenses* of the FWUA and JUA for Year Ended 12/31/2000				
	FWUA	**Percentage of FWUA Premium**	**JUA**	**Percentage of JUA Premium**
Number of Employees	128		56	
Gross Written Premium	$338,491,000	100%	$77,158,783	100%
EXPENSES:				
Salaries	$4,396,871	1.29%	$2,683,598	3.48%
Employee Relations and Welfare	949,508	0.28%	412,181	0.53%
Service Company Fees and Systems Management Fees	(services provided by employees)	0	6,086,628	7.89%
Data Processing	1,394,721	0.41%	(contract fee included in above amount)	
Agent Commissions	34,387,029	10.16%	5,338,451	6.92%
Legal, Audit, and Other Professional Fees	1,227,102	0.36%	1,220,019	1.58%
Investment Manager Fees	1,359,677	0.40%	880,247	1.14%
Surveys and Underwriting Reports	341,508	0.10%	158,474	0.21%
Insurance	298,693	0.09%	166,191	0.22%
Travel and Travel Items	287,515	0.08%	129,114	0.17%
Rent and Rent Expense	733,255	0.22%	409,576	0.53%
Equipment	410,479	0.12%	374,385	0.49%
Printing, Stationary and Supplies	794,188	0.23%	112,681	0.15%
Postage, Telephone, and Telegraph	1,374,910	0.40%	340,321	0.44%
Payroll Taxes	305,177	0.09%	200,236	0.26%
Boards, Bureaus, and Associations	292,650	0.09%	(121,832)	(0.16%)
TOTAL	**$48,553,283**	**14.34%**	**$18,390,270**	**23.83%**
TOTAL (excluding agent commissions)	**$14,166,254**	**4.19%**	**$13,051,819**	**16.92%**

*Expenses do not include loss payments, claims adjustment expenses, reinsurance/Cat Fund premiums, line of credit fees or other financing costs, or JUA take-out bonuses.
Source: JUA and FWUA

The above chart reflects the operating expenses for the FWUA and the JUA related primarily to underwriting and investment functions in 2000. Excluding agent commissions, the FWUA expenses were $14,166,254 and the JUA expenses were $13,051,819, but as a percentage of premium the FWUA expense ratio was much lower, accounting for 4.19% of premium, compared to 16.92% for the JUA.

The lower expense ratio for the FWUA indicates that the in-house servicing performed by its employees is less costly than contracting with private service

carriers, as done by the JUA. But, the JUA probably did not have a reasonable option to hire and train employees when it began in 1993 and wrote over 200,000 policies in less than a year and over 900,000 policies in less than 4 years. Had the JUA eventually elected in-house servicing, it would have then had to reduce its workforce as its policies dropped below 100,000 within another few years. Market fluctuation tends to make contracting with servicing companies a more favorable option. The FWUA, however, was able to handle its significant growth in the mid-1990's, by hiring additional employees and obtaining additional equipment and office space. The FWUA has consistently received very favorable opinions from numerous audits performed of their operations.

The declining premium volume of the JUA also operates to increase its expense ratio. Even though most of the costs are variable costs, such as the service company fees and agent commissions, certain costs are fixed costs that do not decline as premiums decrease, thereby increasing the expense ratio. In prior years, the JUA expense ratio was significantly lower. In 1998, the JUA's expense ratio was only 10.36%, excluding agent commissions, for the expense items listed above and was 17.32% when adding agent commissions. This may be a fairer comparison with the FWUA, because in 1998 the JUA had a much greater premium volume of $353,077,788 in gross written premium, which is comparable to the FWUA's written premium in 2000. In 1999, the JUA's expense ratio rose to 12.87%, excluding agents commissions (19.62% including agent commissions), as its gross written premium dropped to $161,381,000. The number of JUA employees decreased from 77 in 1998, to 63 in 1999, to 56 in 2000, but as a percentage of premium, employee salaries have increased from 1.15% in 1998, to 1.91% in 1999, to 3.48% in 2000. In addition, the higher expenses of the JUA compared to the FWUA may also be due to the added complexity of writing comprehensive policies as opposed to a single-peril policy.

The expense comparison indicates that the greatest opportunity for cost savings if the JUA and FWUA were merged or replaced by a single entity, is by performing in-house servicing with employees, as currently done by the FWUA, rather than contracting with service carriers. In fact, the JUA is establishing in-house servicing staffed with JUA employees to handle 30% to 40% of the JUA's policies in force. The costs are expected to be below that of the JUA's current service companies. The JUA is also replacing its vendor-contracted computer system with a new system expected to improve cost efficiency. The new computer system and the in-house servicing will begin implementation on October 1, 2001.

The operating costs of a merged entity will be less than the costs of the JUA and FWUA operating separately, but the savings would depend on a number of variables, such as the degree to which services are out-sourced or performed internally, the volume of business, the type of coverage offered, and the uses of evolving computer technology.

However, these potential expense savings are not likely to be greater than single-digit millions of dollars, which is a relatively small percentage of the premium. In 2000, even a $10 million reduction in expenses accounts for only 2.4% of the combined premium of the FWUA and JUA.

The greatest underwriting and acquisition expense item is agents' commissions, which are established by the boards. For the FWUA alone, agent's commissions accounted for $34.39 million compared to a total cost of $14.17 million for all other operating expense listed above, including employee salaries and benefits, data processing, professional fees, rent, travel, etc. (Claims adjustment expenses and costs related to financing are not included.) The FWUA pays a nominal commission of 11% and the JUA pays a 10% commission, but certain previous rate increases were not subject to commissions, which substantially accounts for the actual commission expense ratio for the FWUA and JUA being 10.16% and 6.92%, respectively. However, the 96% statewide average rate increase obtained by the FWUA in 2000 (phased-in over a multi-year period) is fully subject to commissions, which will effectively double the average dollar commissions paid, for the same number of policies and, presumably, the same amount of work by the agent. All else being equal, this will increase agent commissions to about $68 million for the FWUA, or over four times the other expenses listed. Reducing agent commissions in the FWUA, even by a small amount, appears to have a much greater potential for costs savings than could be achieved from the effects of merger or reduction in the other expense categories.

Tax Status of the FWUA and JUA

Both the JUA and the FWUA have attempted, and continue to seek, tax exempt status from the federal government. As early as 1993, the JUA began discussions with the Internal Revenue Service ("IRS") seeking a ruling that its income is exempt from federal taxation. In 1999 the JUA formally sought exempt status from the IRS which led to the JUA filing suit in federal court in September, 2000, which is currently pending, claiming a refund for income taxes paid in 1996 through 1999. In addition to these efforts, the FWUA and the JUA have jointly lobbied Congress since 1997 to amend the federal tax laws to provide a specific tax exemption applicable to both associations, which remains a strong possibility.

There are two separate tax exemptions, subject to different legal criteria, that can potentially be achieved for the residual markets: (1) qualifying as tax-exempt entities, to exempt their income (premiums, investments, etc.) from federal taxation; and (2) qualifying as issuers of tax-exempt bonds, for which the interest would not be taxable to the investor, to lower the cost of debt financing.

The efforts of the JUA and the FWUA, to date, have been limited to qualifying as tax-exempt entities. The lawsuit filed by the JUA seeks a determination that it is a tax-exempt entity entitled to refunds of past taxes paid. A favorable ruling would

not necessarily mean that it could also issue tax-exempt securities. Similarly, the federal legislation being sought is limited to classifying both insurers as tax-exempt entities and does not address the tax status of their bonds. However, meeting certain legal criteria could potentially achieve both exemptions.

There are three classifications generally cited under the federal income tax laws that would exempt the income of the JUA or FWUA from taxation: (1) a political subdivision of the state; (2) an integral part of the state, or (3) a separate entity exercising an essential governmental function that accrues to the state. Meeting either of the first two classifications would also qualify an entity as an issuer of tax-exempt bonds. The third classification for issuing tax-exempt bonds is a public authority issuing on behalf of the state.[12]

In 1993, shortly after its establishment, the JUA approached the IRS seeking a ruling granting exempt status pursuant to Section 115 of the Internal Revenue Code, which excludes from taxation income derived from the exercise of any essential governmental function accruing to a state or any political subdivision of the state where the state conducts an enterprise through a separate entity. The IRS indicated its reluctance to issue an exemption ruling due, in part, to the fact that the JUA's income did not "accrue" to the state because the state had no entitlement to JUA funds and had no financial commitment to its obligations, and (2) that a "private benefit" was inherent in the insuring of private property and therefore the activity may not be deemed to be an "essential governmental function."[13]

The JUA filed income tax returns for 1996, 1997, and 1998, and paid a total of $149.9 million in income taxes for those years. In 1998 the JUA reexamined the possibility for obtaining an exemption ruling. Legislative changes had strengthened their legal arguments, including the state's enhanced financial interest in the JUA based on the authority for the association to make emergency assessments against policyholders of member insurers, and providing for the distribution upon dissolution of any remaining assets of the JUA to the Florida Hurricane Catastrophe Fund, rather than to member insurers.[14]

The Florida Hurricane Catastrophe Fund, the state reinsurance fund, was granted tax-exempt status as an "integral part of the state" by an IRS private letter ruling in 1994, following extensive negotiations and enactment of necessary changes to the law.[15] The IRS ruling cited such factors as: (1) direct operation and control of

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[12] Memorandum from Squire, Sanders & Dempsey L.L.P. to James W. Newman, Jr., Executive Director, JUA (March 13, 2001); Revenue Ruling 87-2. 1987-1C.B. 18; Section 115, Internal Revenue Code.

[13] Letter from Arthur Anderson L.L.P. (Robert Tache) to Mr. James W. Newman, Jr., Executive Director, JUA (November 18, 1998).

[14] Id.

[15] IRS Private Letter Ruling 9507307, Nov. 21, 1994. Revisions to the proposed

the Fund by the State Board of Administration (Governor, Comptroller, and Treasurer); (2) exercise of the state's power to collect assessment revenues from non-participants (auto insurers, primarily) who do not receive any consideration from the Fund; (3) annual state appropriations from the Fund for specified purposes unrelated to its contractual obligations to insurers; and (4) state receipt of assets of the Fund upon termination. The ruling was contingent upon the passage of proposed amendments to the law, which were then enacted in Special Session in 1995, which included a $50 million state appropriation to the Fund ($25 million from General Revenue and $25 million from the Insurance Commissioner's Regulatory Trust Fund, over 2 years); an increase in maximum insurer assessments from 2% to 4% of premiums; and a minimum $10 million annual appropriation from the Fund for a wider range of hurricane loss mitigation projects.[16]

In November 1999, the JUA officially pursued tax-exempt status in the form of a "Technical Advice Submission Request" to the IRS, followed by a meeting with the IRS and a supplemental filing on May 8, 2000. The request detailed the JUA's position that it is: (1) a political subdivision of the state, and (2) an integral part of the state. Meeting either classification would make the JUA a tax-exempt entity. As precedent, the JUA cited an 11th Circuit Court of Appeals case finding the JUA to be a "political subdivision" of the state for purposes of being entitled to immunity from federal anti-trust laws.[17] Also cited were prior IRS private letter rulings which determined that three state-created disaster relief organizations were an "integral part" of their states, including the California Earthquake Fund, the Hawaii Hurricane Relief Fund, and the Florida Hurricane Catastrophe Fund.[18]

The JUA's argument that it is a "political subdivision" of the state is based on the state giving it the "power to tax" in the form of assessments, particularly emergency assessments against non-JUA policyholders who receive no consideration in return for the assessments.

The argument that the JUA is an "integral part" of the state is based on: (1) state control over the JUA and (2) a significant state financial commitment to the JUA, which are the two conditions that must both be satisfied, based on prior IRS rulings. The JUA also emphasized the public purpose goals served by the JUA.

Some of the elements of state control cited by the JUA include:

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legislation required a supplemental ruling on March 6, 1995, finding that the modified legislation did not adversely affect the analysis in the initial ruling.

[16] Chapter 95-1, L.O.F.

[17] *Bankers Ins. Co. v. Florida Residential Property and Casualty Joint Underwriting Ass'n.*, 137 F.3d 1293 (11th Cir. 1998).

[18] Private Letter Rulings 9622019 (Cal.) 9627016 (Ha.), and 9507307 (Fla.), as cited in *Technical Advice Submission Request* by the Florida RPCJUA, Nov. 2, 1999.

- Insurance Commissioner appointment of a majority of JUA board members;
- Department approval of the JUA plan of operation;
- Mandatory JUA membership of all insurers authorized to write specified lines;
- State receipt of all remaining assets of the JUA upon dissolution.

The public purpose goals cited by the JUA include: helping Florida citizens recover from a catastrophe; responding to a statewide private market crisis; and prevention of harm to the economy of the state.

The financial involvement of the state, as documented by the JUA, is demonstrated by the following:

- JUA exemption from Florida's corporate income tax and intangible property tax, amounting to $23.5 million and $1.3 million, respectively, through 12/31/99;
- JUA exemption from premium tax through mid-June, 1995, amounting to $11.1 million, as well as exemption from municipal taxes during that period, (but the JUA has been subject to the premium tax since 1995);
- Requirement for the JUA to make regular assessments on insurers (recouped against policyholders), emergency assessments directly on all property insurance policyholders, and market equalization surcharges on JUA and FWUA policyholders;
- JUA authority to issues bonds and to take all actions needed to facilitate tax-free status of bonds, with the state prohibited from taking any action to impair any bonds;
- Department authority to order insurers to purchase unsold JUA bonds;
- Insurer liability for assessments after an insurer stops writing insurance in Florida, until 12 months after the end of the calendar year the insurer withdraws;
- State receipt of the remaining assets of the JUA upon dissolution.

The JUA also listed other factors supporting the conclusion that it is an integral part of the state, including:

- Prior judicial determination that the JUA is a political subdivision entitled to state immunity from federal antitrust laws;
- Statutory immunity to JUA board members;
- Application of the Florida Sunshine Law, requiring public meetings and public records for the JUA;
- Public ability to legally challenge the JUA's decision making process through the state Administrative Procedure Act;

- JUA authority to obtain bonding assistance from any other unit of local government;
- JUA status as an authorized investor in the State Treasurer's Special Purpose Investment Account.

One of the primary concerns expressed by the IRS involved whether, and how much the State of Florida contributed financially to the JUA during its existence. The IRS questioned whether the indirect financial contribution by the state resulting from the tax exemptions, itemized above, resulted in real dollars contributed to the JUA. In response, the JUA has attempted to demonstrate to the IRS that the premium rates charged for JUA policies included components which represented payment for the exempted taxes, and that the JUA has been collecting such amounts and retaining them rather than remitting them to the state.

Another concern of the IRS is the advisory opinion rendered by the Florida Supreme Court in 1995 related to the state revenue cap.[19] In response to Governor Chiles' request for an opinion, the Court determined that assessments, policy premiums, and policy surcharges imposed by the JUA were not "state revenues" within the meaning of the revenue cap provisions of the Florida Constitution. At that time, the JUA was negotiating its first line of credit secured by assessments. The financial institutions were very concerned that such assessments would be considered "state revenues" that would be limited by the revenue cap provisions of Article VII, Section 1(3), of the Florida Constitution. This provision specifically exempts from the revenue cap receipts of the Florida Hurricane Catastrophe Fund, but does not address joint underwriting associations. At that time, all parties involved wanted the Supreme Court to find that the assessments were not state revenues under the revenue cap, so that the line of credit could be obtained and the JUA's future long-term financing would not be handicapped. In reaching its finding that JUA revenues were not state revenues, the Supreme Court noted the express statutory provision that the JUA is not a state agency, board or commission;[20] that the acceptance or rejection of a risk by the JUA is construed as the private placement of insurance and the provisions of the Administrative Procedure Act do not apply;[21] that the premiums and assessments collected by the JUA are not "imposed by the Legislature"; that the JUA is not performing a traditional governmental function; and that the JUA's revenues are not subject to legislative appropriation. In its filings with the IRS and, presumably, in its current lawsuit, the JUA argues that Florida Supreme Court advisory opinions are not legal precedent and that the issues before the court were different from the issues relating to the tax exempt status of the JUA.

Having been unsuccessful in obtaining a favorable ruling from the IRS, the JUA board took its argument to court, filing an action in the U.S. District Court for the

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[19] *In re Advisory Opinion to the Governor--State Revenue Cap*, 658 So.2d 77 (Fla. 1995).
[20] Section 627.351(6)(j), F.S.
[21] Section 627.351(6)(c)8.b., F.S.

Northern District of Florida in September 2000, for a refund of federal income taxes paid in years 1996 through 1999. At this time, the lawsuit is still pending and a mediation conference is scheduled in September 2001.

In addition to the JUA's separate efforts, the FWUA and JUA have jointly lobbied Congress since 1997 to amend the Internal Revenue Code to provide tax-exempt status to their types of joint underwriting associations. The FWUA was treated as a partnership for federal and state income tax purposes since 1970 and, therefore, was not subject to such taxes. Beginning in 1997, after legislative changes prohibited the FWUA from distributing surplus funds to member insurers, the FWUA elected to be treated as a corporate federal and state tax filer.

The 1999 Congress included in its major tax package provisions exempting the FWUA and JUA from federal income taxes, under criteria that also applied to the Texas Windstorm Underwriting Association. But, the tax legislation was vetoed by President Clinton for reasons unrelated to these provisions.

This year, efforts continue to pass legislation classifying the FWUA and RPCJUA as tax-exempt entities, as filed in S. 797 sponsored by Senators Phil Gramm (R-TX) Kay Hutchison (R-TX), Bob Graham (D-FL) and Bill Nelson (D-FL), and identical H.R.1789 filed by Representative Clay Shaw (R-FL) and seventeen co-sponsors from the Florida delegation, plus one Texas co-sponsor. According to the associations' lobbyists, Congress has begun to focus on the various business-related and miscellaneous tax provisions not included in the tax package enacted earlier in 2001. Business tax measures were deferred and agreed to be addressed later. Several business tax packages are now under consideration which could serve as legislative vehicles to which S. 797 and H.R. 1789 could be added. The Senate Democratic leadership has indicated that they plan to act on tax legislation, but will require that the cost of any such bills must be largely offset. In 1998, the Congressional Joint Committee on Taxation prepared an official estimate of the legislation classifying the FWUA, RPCJUA, and Texas Windstorm Pool as tax-exempt and concluded that it would reduce federal revenues by $1 million over 10 years, a figure which is de minimums for federal budget purposes. It is generally determined that as taxable entities, the taxes paid would be largely offset by tax deductions for claims payments (carried over to profitable years) over the long-term.[22]

To qualify for tax-exempt status under S. 797/H.R. 1789, an association must have been created by state law before January 1, 1999, or "any successor organization," to provide property and casualty insurance, with respect to which coverage in the authorized insurance market is not reasonably available to a substantial number of insurable real properties, and if:

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[22] Memorandum to the FWUA and JUA from Matthew J. Dolan, Baker & Hostetler L.L.P., July 27, 2001; Memorandum to the JUA from Matthew J. Dolan, Nov. 18, 1998.

- no part of the net earnings inures to the benefit of any private individual;
- no part of the assets may be used for any purpose other than to satisfy claims, to invest in authorized investments, pay reasonable and necessary expenses, purchase reinsurance, or to support governmental programs to prepare for or mitigate the effects of catastrophes;
- state law permits the association to levy assessments on insurers or policyholders to fund deficits or create reserves;
- the plan of operation is subject to approval by a state official or by the state Legislature, and
- the assets revert upon dissolution to the state.

Department of Insurance Proposal: "Citizens Property Insurance Corporation"

The Department of Insurance proposed legislation in 2001 to merge the FWUA and JUA into a successor organization, named the Citizens Property Insurance Corporation, or "CPIC." This proposal was contained in Senate Bill 2234 by Senator Garcia, made a Committee Substitute by the Banking and Insurance Committee, withdrawn from the Governmental Oversight and Productivity Committee, and died in the Finance and Taxation Committee. The companion was House Bill 1643 by Representatives Goodlette and Bennett, favorable with one amendment by the Committee on Insurance; died in the Committee on Fiscal Policy and Resources. The department is expected to propose similar legislation for the upcoming session.

The department's primary goal is to enable CPIC to issue tax-exempt bonds and to ensure that its income is exempt from federal income taxation. Outside legal counsel advised that, under certain conditions, CPIC could issue tax-exempt securities as an "integral part of the State" or as a "public authority issuing on behalf of the State." Similarly, it was advised that CPIC's income could be exempt from taxation by being classed as an "integral part of the State" or as a "separate entity exercising an essential governmental function that accrues to the State." The legislation was said to be a substantial improvement over the current JUA and FWUA statutes in terms of achieving these objectives, due particularly to "(i) the clear and unambiguous declaration of an imperative public purpose, (ii) the re-characterization of the nature of the entity - in order to highlight that it is a legislative created and mandated answer to the havoc wreaked by Hurricane Andrew, as opposed to a traditional, industry-initiated and controlled association, and (iii) the unequivocal State control over the entity."[23]

[23] Memorandum from Squire, Sanders & Dempsey L.L.P. to James Newman, Jr., Executive Director, FRPCJUA, March 13, 2001.

CS/SB 2234 provided that CPIC would be governed by a seven-member board appointed by, and serve at the pleasure of, the Insurance Commissioner. This is the primary feature of the bill that established state control of CPIC, deemed essential for tax-exempt status under the "integral part of the State" analysis. No specific qualifications or expertise were required for any of the board members.

To be deemed an integral part of the State, there must also be a significant state financial commitment to the entity. Tax counsel advised that the IRS appears to be looking for the state to contribute, either annually or up front, a significant amount from tax or other revenues to the entity. Merely providing a tax exemption or providing that the assets of the entity will revert to the state upon dissolution may not be enough to satisfy the financial commitment requirement. Even giving the entity the power to levy assessments, as provided to the JUA and FWUA, for a public purpose may not be sufficient. A significant financial commitment was satisfied by the Florida Hurricane Catastrophe Fund by virtue of the state appropriating $50 million to the Fund, in addition to the requirement for the state to make annual appropriations from the Fund for public purposes related to hurricane loss mitigation and hurricane preparedness.

To provide a significant financial commitment, the CPIC legislation utilized a "premium tax equivalent" provision modeled on a provision of the California Earthquake Authority which was ruled by the IRS to be an integral part of the State. That Authority charges all policyholders an amount equal to the amount of the premium tax, but is itself exempt from the premium tax. The IRS concluded that this was the same as the State collecting the premium tax and contributing the full amount to the Authority, estimated to be $24 million annually. (Certain other elements of the California's financial interest were also considered.) CS/SB 2234 similarly provided a premium tax exemption to CPIC, while requiring that an amount equivalent to the tax (1.75%) be added to the approved premium charged to policyholders. It was estimated that this would have a negative fiscal impact on General Revenue of about $5.25 million (the bill died in the Senate Finance and Taxation Committee).

Other features of the CPIC legislation were designed to assure that outstanding debt obligations of the FWUA and JUA would not be impaired. CS/SB 2234 provided that CPIC assumed all rights and obligations of the FWUA and JUA. CPIC was also required to maintain three separate accounts as currently maintained by the two associations (one FWUA account and two JUA accounts), so that the same premium assessment base would be used to fund current debt obligations, providing the same revenue stream, as under current law. After all outstanding debt obligations are satisfied, however, the bill would have allowed the CPIC board to "merge the accounts." This is somewhat vague, but could result in adding commercial property insurance premiums into the assessment base for the combined entity. Currently, such premiums are only assessable in the FWUA and in the JUA commercial residential account, but not the JUA personal lines

residential account. This could provide additional bonding capacity, but could also create market instability in the commercial property market.

Another difficult issue is the extent and type of coverage that should be offered by the residual market. Currently, the FWUA writes wind-only coverage in limited areas, and the JUA writes full coverage outside of those areas. Debates regarding the appropriate boundaries of the FWUA revolve around the issue of encouraging insurers to write windstorm coverage. Insurers are allowed to write non-wind policies for property in FWUA-areas. But, outside FWUA areas, insurers must issue policies that provide full coverage, including windstorm, or not write the coverage at all. This provides a greater incentive to an insurer to write the windstorm coverage, since that is the only way the insurer will be permitted to write the non-wind coverage. This was the primary reason why the Legislature in 1998 prohibited further expansion of the FWUA boundaries, believing that there would be lower overall exposure to the residual market.

Based on this theory, SB 2234, as filed, provided that CPIC would offer full residential coverage statewide. The only wind-only coverage was to be provided to commercial non-residential risks (businesses) in current FWUA-eligible areas. This was intended to force insurers to choose between writing full coverage or no coverage, and thereby encourage those insurers currently writing non-wind coverage in FWUA-eligible areas to pick up the windstorm coverage. Another argument given, was to provide the consumer with a single policy, rather than separate wind and non-wind policies. But, concerns were raised due to the impact on the solvency of those insurers which have a significant amount of non-wind business. This led to revisions made in CS/SB 2234 that provided for CPIC to “coinsure” the hurricane risk in current FWUA-areas with the private insurer writing the non-hurricane coverage. CPIC and the private insurer would each be severally responsible for a specified percentage of the hurricane coverage for a specified risk. The bill required CPIC to provide coinsurance levels of 80 percent and 50 percent. Additional levels of coinsurance were authorized, but CPIC’s percentage could not exceed 80 percent.

The coinsurance concept is untested and could prove difficult to administer. For one, it would impose greater administrative burdens on the Florida Hurricane Catastrophe Fund to determine the appropriate premium and coverage amount for each insurer and the CPIC, because both the insurer and CPIC must report exposure data that will have to be reconciled. Second, the coinsurance concept is intended to result in a single policy to the consumer (one of the goals of the department), but it is questionable how this would be done. If CPIC and the private insurer are each severally liable for a portion of the hurricane coverage, it appears to demand two separate contractual obligations to the policyholders. A private insurer may be reluctant to provide a single contract that potentially exposes it to full liability if CPIC is unable to fully meet its obligations.

Other options would be for CPIC to simply provide the same coverage currently offered by the FWUA and JUA, or to move the current FWUA boundary seaward. One proposal that has often been discussed is to move the boundary from I-95 to U.S. 1 in Dade, Broward, and Palm Beach Counties. This would encourage those insurers writing the non-wind coverage to write full coverage, under the threat of losing the risk entirely. But, it would not be as disruptive as completely eliminating wind-only coverage in the residual market, and not as difficult to administer as the coinsurance concept.

Another contentious issue is the "forced take-out" provisions of the current FWUA and JUA laws. If any authorized insurer offers coverage to a residual market policyholder at the insurer's approved rates, the policyholder is no longer eligible for coverage in the FWUA or JUA. These provisions were enacted to assure that the FWUA and JUA are insurers of last resort, due to their exposure to deficit assessments on all policyholders in the state. CS/SB 2234 contained the same provision for CPIC. Policyholders may be upset when told that coverage will be provided by an insurer they may not have heard of, particularly if their premium is higher. Even though they are not required to accept the coverage, they may have no other choice if no other insurer is willing to provide coverage. On the other hand, the residual market is intended to provide coverage only if it is unavailable in the private market. The exposure to multi-billion dollar assessments underscores this limited purpose. If an authorized insurer can provide coverage, there is little argument that the residual market should do so. The recent FWUA rate increase will make it less likely that a policyholder taken out of the FWUA will experience a rate increase. But, concerns have been raised about the solvency of some of the JUA take-out companies, as discussed in an interim project of this committee last year (Whether Florida's Insurance Laws are Adequate to Respond to the Next Major Hurricane, Report Number 2001-01, Committee on Banking and Insurance).

Conclusions and Recommendations

The JUA was intended to be a temporary solution to a market crisis, but property insurance coverage remains unavailable for tens of thousands of residential structures in south Florida in areas that are not eligible for windstorm coverage in the FWUA. A permanent facility is also needed to be ready to write full, statewide coverage if another hurricane causes a statewide market crisis. Therefore, it is recommended that:

1. The Legislature should consider merger of the FWUA and the JUA into a single, permanent residual market entity. There is no reason to have two entities providing property insurance coverage. A merger is likely to achieve modest expense savings and would better enable the Legislature and regulators to achieve consistent public policy objectives. The

relatively stable insurance market makes it an opportune time to implement a merger.

2. The acquisition costs and underwriting expenses of the FWUA, as a percentage of premium, are much lower than those of the JUA, due primarily to in-house servicing, rather than contracting with private carriers. Expense savings by merger of the FWUA and JUA could be achieved by in-house servicing. However, such savings would be modest compared to overall costs, and are not likely to result in premium reductions to consumers. Greater expense savings could be achieved by even a small reduction in agent commissions paid by the FWUA.

3. Obtaining tax-exempt status for the residual market would provide significant savings and should be aggressively pursued, but this can be attempted either for a merged entity or separately for the FWUA and the RPCJUA. Legislation may not be necessary if federal legislation is passed that would classify both the FWUA and JUA as tax-exempt entities. The JUA also has a pending lawsuit against the federal government seeking tax-exempt status. Tax-exempt financing by both associations can likely be obtained under current Florida law which authorizes municipalities to issue bonds backed by FWUA and JUA assessments. The key factors to obtaining tax-exempt status for any entity as an "integral part of the state" are state control and a substantial state financial commitment.

4. Implementing a merger of the JUA and FWUA is made much more difficult if the new entity is faced with the additional change to "coinsuring" or sharing the hurricane risk with private carriers. Merger could be accomplished relatively seamlessly, with fewer potential adverse consequences, by maintaining the types of coverage currently provided -- full coverage in non-FWUA areas and wind only (or, hurricane-only) in FWUA areas. Many complexities are inherent in the coinsurance concept, which could also raise concerns in the financial markets. A more viable option to provide additional incentive to insurers to write hurricane coverage is to reduce the size of the FWUA-eligible areas to force carriers to either write full coverage or no coverage. This could be limited to new policies to mitigate the financial impact on carriers currently writing non-wind policies in the affected areas.