The Florida Senate

BILL ANALYSIS AND FISCAL IMPACT STATEMENT

(This document is based on the provisions contained in the legislation as of the latest date listed below.)

Prepared By: The Professional Staff of the General Government Appropriations Committee

BILL: CS/CS/SB 1422

INTRODUCER: General Government Appropriations Committee, Banking & Insurance Committee, and Senator Bennett

SUBJECT: Commercial Property Insurance

DATE: April 22, 2008 REVISED:

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	Knudson	Deffenbaugh	BI	**Fav/CS**
2.	Rogers	Cooper	CM	**Favorable**
3.	Kynoch/Knudson	DeLoach	GA	**Fav/CS**
4.				
5.				
6.				

Please see Section VIII. for Additional Information:

A. COMMITTEE SUBSTITUTE..... [X] Statement of Substantial Changes
B. AMENDMENTS........................ [ ] Technical amendments were recommended
[ ] Amendments were recommended
[ ] Significant amendments were recommended

I. Summary:

This bill permits insurers to sell “nonassessable commercial property insurance,” which is not subject to a determination by the Office of Insurance Regulation that the rate is excessive pursuant to s. 627.062, Florida Statutes, and is not subject to assessments by the Florida Hurricane Catastrophe Fund and Citizens Property Insurance Company. The bill also requires notice to the consumer in the application for nonassessable commercial property insurance and on the declarations page of the policy that the policy is subject to limited rate regulation and not subject to Florida Hurricane Catastrophe Fund and Citizens assessments.

The bill substantially amends sections 215.555, 627.041, 627.062, and 627.351, Florida Statutes.

The bill creates section 627.7031, Florida Statutes.

II. Present Situation:

Ratemaking Regulation for Property, Casualty, and Surety Insurance

The Rating Law for property, casualty, and surety insurance is located in Part I of ch. 627, F.S., (ss. 627.011 – 627.311, F.S.). The primary purpose of the Rating Law is to ensure that insurance rates are not excessive, inadequate, or unfairly discriminatory. This is the standard that every insurance rate regulated by this part is held to. Every rate for the classes of insurance that the Rating Law applies to must be submitted by the insurer to the Office of Insurance Regulation (OIR), which reviews the rate and either approves or disapproves the rate. Generally, insurers may either choose to submit their rate to the office via a “file and use” method or “use and file” method. In a “file and use” filing, the insurer submits to the OIR their proposed rate at least 90 days before the rate’s effective date and chooses not to implement the rate until it is approved. In a “use and file” filing, the insurer files with the department within 30 days of the rate’s effective date, and if the rate is disapproved may have to refund to policyholders the portion of the rate that is excessive.

In determining whether a rate is excessive, inadequate, or unfairly discriminatory, the office uses the following statutory factors.

- Past and prospective loss experience in Florida and in other jurisdictions.
- Past and prospective expenses.
- Degree of competition to insure the risk.
- Investment income reasonably expected by the insurer.
- Reasonableness of the judgment reflected in the filing.
- Dividends, savings, or unabsorbed premium deposits returned to Florida insureds.
- Adequacy of loss reserves.
- Cost of reinsurance.
- Trend factors, including those for actual losses per insured unit.
- Catastrophe and conflagration hazards, when applicable.
- A reasonable margin for underwriting profit and contingencies.
- Cost of medical services, when applicable.
- Other relevant factors impacting frequency and severity of claims or expenses.

Commercial Non-Residential Property Insurance

There are three basic types of property insurance that cover structures in Florida:

- Personal Residential – Includes homeowner’s, mobile home owner’s dwelling, tenants, condominium unit owners, cooperative unit owners, and similar policies.
- Commercial Residential – Coverage provided for condominium associations, cooperative associations, apartment buildings, and similar policies.
- Commercial Non-Residential – Coverage provided for commercial businesses.

Commercial non-residential property insurance covers a policyholder’s business, providing reimbursement due to damages sustained by a business property, including windstorm damage.

A commercial property policy is usually crafted to take into account the amount of coverage the business needs, the construction type of the business, and the occupancy of the property. Because commercial property policies span many different types of businesses with a great variety of structures (shopping malls, manufacturing plants, medical facilities, and small retail businesses are some examples) there is a wider array of product types and coverage options than are found in the personal residential and commercial residential product lines. Most large commercial businesses obtain insurance with an individual risk rate, meaning the rate on the coverage is specifically set for the property insured and is negotiated by the business owner and the insurer. In this circumstance, the rate is essentially deregulated and is not set in accordance with the insurer's rates, rating schedules, rating manuals, and underwriting rules filed with the OIR.

Assessments on Commercial Non-Residential Property Insurance

Commercial property insurance policies are currently assessable for deficits in the Florida Hurricane Catastrophe Fund (FHCF), the Florida Insurance Guaranty Association (FIGA), and by Citizens Property Insurance Corporation. The FHCF may levy an emergency assessment of up to 6 percent of premiums for losses arising out of a single contract year, up to 10 percent for losses spanning multiple years. Assessments by the FHCF can be collected over a period of up to 30 years. Assessments from FIGA can be levied up to a maximum of 2 percent of the insurer's direct written premium for that year, while emergency assessments of up to 2 percent can be levied for the life of the bonds supporting the assessment.

The Citizens assessment structure is complex. When a deficit is incurred in any of the three Citizens accounts (high risk, personal lines, or commercial lines), the board must levy assessments for each account that has a deficit, in the following order as necessary:

1) An immediate assessment of up to 10 percent of premium against all Citizens' nonhomestead policyholders (as defined).
2) If this is insufficient, an additional assessment of up to 10 percent of premium against all Citizens' policyholders (including nonhomestead), collected upon issuance or renewal of a policy.
3) If this is insufficient, a regular assessment against insurers which may be recouped by the insurer in a rate filing from its policyholders, of up to 10 percent of premium for most lines of property and casualty insurance, or 10 percent of the deficit, whichever is greater.
4) Any remaining deficit is funded by a bond issue, funded by multi-year emergency assessments on policyholders of most types of property and casualty insurance, of up to 10 percent of premium, or 10 percent of the deficit, whichever is greater.
5) If a regular assessment is imposed under 3), above, Citizens must make a rate filing to impose a surcharge on Citizens policyholders equal to the average percentage of regular assessment imposed on insurers (and recouped from non-Citizens policyholders).

Chapter 2007-1, L.O.F., (HB 1-A) expanded the types of insurance policies and premiums that are subject to assessments to fund deficits of Citizens, previously limited to property insurance premiums. As expanded, the assessment base is substantially the same as that of the Florida Hurricane Catastrophe Fund, which includes all lines of property and casualty insurance, including auto insurance, but not workers' compensation, medical malpractice, or accident and health. This expanded the assessment base four-fold, from about $8.2 billion to approximately

$34 billion for regular assessments and $37 billion for emergency assessments. This reduced the percentage assessment that may be imposed in the future by about one-fourth, by spreading it to additional types of insurance, notably auto policies, and helps to support much larger bond issues, if necessary.

The Florida Hurricane Catastrophe Fund (FHCF)

The FHCF is a tax-exempt trust fund created in 1993 after Hurricane Andrew as a form of mandatory reinsurance for residential property insurers, (s. 215.555, F.S.) All insurers that write residential property insurance in Florida are required to buy reimbursement coverage (reinsurance) on their residential property exposure through the FHCF. The FHCF is administered by the State Board of Administration (SBA) and is a tax-exempt source of reimbursement to property insurers for a selected percentage (45, 75, or 90 percent) of hurricane losses above the insurer's retention (deductible). The FHCF provides insurers an additional source of reinsurance that is significantly less expensive than what is available in the private market, enabling insurers to generally write more residential property insurance in the state than would otherwise be written. Because of the low cost of coverage from the FHCF, the fund acts to lower residential property insurance premiums for consumers. The FHCF must charge insurers the "actuarially indicated" premium for the coverage provided, based on hurricane loss projection models found acceptable by the Florida Commission on Hurricane Loss Projection Methodology.

Insurers must first pay hurricane losses up to their "retention" for each hurricane, similar to a deductible, before being reimbursed by the FHCF coverage. In 2005, legislation addressed multiple storm seasons by providing that the retention is reduced to one-third of the regular retention for a third hurricane and each additional hurricane. The full retention is applied to the two hurricanes causing the greatest losses to the insurer. The retention is adjusted annually based on the FHCF's exposure. For the 2007 hurricane season the retention was approximately $6.1 billion for all insurers combined. A retention is calculated for each insurer based on its share of fund premiums.

For the 2007 hurricane season the FHCF provided $15.85 billion in mandatory coverage. That amount is adjusted annually based on the percentage growth in fund exposure, but not to exceed the dollar growth in the cash balance of the fund. The maximum coverage amount for each insurer is based on that insurer's share of the total premiums paid to the fund.

House Bill 1-A added two additional layers of optional coverage that property insurers may buy for the 2007, 2008, and 2009 hurricane seasons:

- Temporary Increase in Coverage Limit options ("TICL"), that allow an insurer to purchase additional reinsurance for its share of up to $12 billion, in $1 billion increments, above the FHCF annual limit of the mandatory coverage (i.e., up to a total of approximately $28 billion). The SBA may further increase the limits by an additional $4 billion (i.e., up to $32 billion). The SBA did not increase the limits in 2007.
- Temporary Emergency Additional Coverage Options ("TEACO"), that allows residential property insurers to purchase additional coverage below each insurer's market share of the FHCF retention. For 2007, the FHCF retention was $6.1 billion. The TEACO options allow

an insurer to select its share of a retention level of $3 billion, $4 billion, or $5 billion, to cover 90 percent, 75 percent, or 45 percent of its losses up to the normal retention for the mandatory FHCF coverage.

The 2007 law also allowed eligible insurers to each purchase up to $10 million in additional FHCF coverage, explained in more detail below.

If the cash balance of the FHCF is not sufficient to cover losses, the law allows the issuance of revenue bonds of up to 30-year terms, funded by emergency assessments on property and casualty policyholders. The FHCF is authorized to levy emergency assessments against all property and casualty insurance premiums paid by policyholders (other than workers' compensation, flood, medical malpractice, and accident and health insurance), including auto insurance and surplus lines policyholders. Annual assessments are capped at 6 percent of premium with respect to losses from any 1 year and a maximum of 10 percent of premium to fund hurricane losses from multiple years.

Current Financial Status of the FHCF

The Florida Hurricane Catastrophe Fund had potential reimbursement obligations to insurers of $27.85 billion for the 2007 hurricane season. This amount consisted of:

- $15.85 billion of mandatory FHCF coverage (subject to a growth factor each year).
- $11.43 billion of TICL coverage selected by insurers (of the optional $12 billion offered only for 2007, 2008, and 2009).
- $557 million selected by limited apportionment insurers eligible to purchase up to $10 million additional coverage (offered only for 2007).

To fully meet the potential $27.85 billion obligation for 2007, the FHCF relied on:

- $2.08 billion estimated year-end cash balance.
- $6.3 billion in proceeds from pre-event notes that have already been issued (for short-term liquidity needs).
- Up to $25.75 billion in bonds to be issued after a hurricane (which could be used to retire the pre-event notes).

The FHCF had potential reimbursement obligations to insurers of $27.85 billion for the 2007 hurricane season, for which the FHCF would have been required to issue up to $25.75 billion in post-hurricane bonds. This would require an annual assessment of about 5 percent of premiums for 30 years. Even if this full obligation was triggered, the FHCF faces similar obligations for 2008 and 2009, due to the TICL options. The FHCF estimates that its maximum potential obligations for two years of about $56 billion would require the maximum allowable assessment of 10 percent annually for 30 years.

A bond issue of $26 billion would be unprecedented and may require multiple bond issues over a period of time, while attempting to match time frames for insurers to pay claims and obtain timely reimbursement. The largest single long-term tax exempt financing ever done was for just over $6 billion, but there have been programs consisting of multiple financings over a period of several months for over $10 billion, and the largest single municipal financing was a taxable pension financing of $10 billion. But there are over $2.5 *trillion* in tax-exempt municipal bonds currently held (of which over $900 billion are held by households alone), reflecting a large market appetite for such securities. When interviewed by committee staff in November, 2007, the financial advisor for the FHCF believed that the full amount of potential bonding needed could be issued by the FHCF over a 9 to 18 month period in a series of several issues. This belief was based in part on written opinions earlier that summer from each of the three senior managers of the FHCF -- Bear Stearns, Goldman Sachs, and Lehman Brothers -- each of whom said that they believed the entire amount was achievable in a similar or shorter time frame. Currently, the continuing fallout of the subprime mortgage market and recent downgrades by financial rating organizations of insurers writing bond insurance have reportedly had a negative impact on the issuance of municipal bonds and other tax-exempt government issued bonds.

The largest insurance rating service, A.M. Best, expressed concern that the FHCF may be unable to issue bonds to produce its maximum claim-paying capacity through the TICL layer. In a February, 2007 report issued shortly after HB 1-A was enacted, A.M. Best raised the credit risk factor for reinsurance recoverables from the FHCF from 4 percent to 12 percent, meaning that for purposes of rating the financial strength of an insurer, the reinsurance recoverables from the FHCF are reduced 12 percent.

The probability of the full $28 billion loss (requiring a $26 billion bond issue) to the FHCF occurring in any given year is relatively low, but not remote. This would require a hurricane resulting in about $36 billion of insured residential hurricane losses (including the losses covered by the insurers' $6.1 billion retention and 10 percent or greater co-pay), which is estimated to have a probability of 1.6 percent, or a hurricane that occurs about once every 65 years. By comparison, the probability of loss to the FHCF for the full $15.85 billion mandatory coverage, but without the TICL coverage, is estimated to be about 3 percent, or once every 33 years. The probability of any loss at all to the FHCF (i.e., a loss above the industry retention of $6.1 billion) is 13.33 percent, or once every 7.5 years.

III. Effect of Proposed Changes:

Section 1 amends s. 215.555(6)(b), F.S., to exempt "nonassessable commercial property insurance" from emergency assessments by the Florida Hurricane Catastrophe Fund.

Section 2 amends s. 627.041, F.S., creating definitions for "assessable commercial property insurance" and "nonassessable commercial property insurance." The definitions differ in that "assessable commercial property insurance" is subject to the rate standards of s. 627.062, F.S., and deficit assessments by the Florida Hurricane Catastrophe Fund and Citizens, while "nonassessable commercial property insurance" is not subject to the rate standards of s. 627.062, F.S., except for a determination of rate inadequacy or subject to deficit assessments by the FHCF and Citizens.

Section 3 amends s. 627.062, F.S., the rate standards for insurance. The bill creates a new paragraph (2)(k) and states that:

- Nonassessable commercial property insurance is not subject to a determination that the rate is excessive or unfairly discriminatory.
- However, the OIR may disapprove such a rate as inadequate or for unlawful use of unfairly discriminatory rating factors that are prohibited by Florida law.
- These provisions in this paragraph do not apply to filing for commercial lines residential insurance or assessable commercial property insurance.

Section 4 amends s. 627.351(6)(b)3.f., F.S., to include nonassessable commercial property insurance among the lines of property and casualty insurance that are not subject to assessment by Citizens in the event of a Citizens deficit incurred on or after January 25, 2007. Insurance companies that issue nonassessable commercial property insurance policies are not subject to assessment on the premiums that it writes for nonassessable commercial property insurance policies.

Section 5 creates s. 627.7031, F.S. The new section:

- Permits insurers offering assessable commercial property insurance to also offer nonassessable commercial property insurance policies.
- States that owners of commercial property may purchase a nonassessable commercial property insurance policy if one is offered by the insurer.
- The application and declarations page for a nonassessable commercial property insurance policy must each contain a disclaimer in 12-point boldfaced type that the insurance is subject to limited rate regulation requirements of Florida law but is not subject to deficit assessments by the Florida Hurricane Catastrophe Fund and Citizens, and that a commercial property insurance policy that is subject to rate regulation and deficit assessment by the FHCF and Citizens is available.

Section 6 provides an effective date of July 1, 2008.

IV. Constitutional Issues:

A. Municipality/County Mandates Restrictions:

None.

B. Public Records/Open Meetings Issues:

None.

C. Trust Funds Restrictions:

None.

V. Fiscal Impact Statement:

A. Tax/Fee Issues:

None.

B. Private Sector Impact:

Businesses covered by nonassessable commercial insurance policies will be relieved of any assessments for deficits in the FHCF and Citizens, particularly after a major hurricane. Nonassessable policies are likely to have higher premiums than those that are regulated by the OIR, but some businesses may be willing to pay the higher premium in exchange for not being subject to assessment by the FHCF and Citizens (though they will still be subject to FIGA assessments). The greater cost certainty may also prove attractive for businesses considering opening in Florida, and reduces the negative financial impact on businesses stemming from a FHCF or Citizens assessment.

The bill will reduce the assessment base of the FHCF and Citizens through the removal of some commercial property insurance policies. If the FHCF and Citizens assessment bases are reduced, then insurance policies that remain in each assessment base will be subject to higher assessment costs than currently. The degree to which the assessment base will be reduced cannot be determined because it is unknown how many businesses will choose to purchase the new nonassessable coverage. Citizens reports that commercial non-residential annual premium was estimated by OIR via a data call in 2006 to both authorized insurers and surplus lines insurers, to be $1.2 billion. However, an October 2007 report from the FHCF estimates that the total direct written premium for commercial property insurance, including surplus lines, to be approximately $3 billion. These estimates represent a range of about 3.5 percent to 8.8 percent of each assessment base, which would not materially affect the bases of the FHCF or Citizens.

C. Government Sector Impact:

At the April 22, 2008 committee meeting of the General Government Appropriations Committee, the Senior Executive Officer of the Florida Hurricane Catastrophe Fund testified that exempting nonassessable commercial property insurance from the FHCF emergency assessment base could negatively impact the federal tax-exempt status of the FHCF. The FHCF is undergoing an Internal Revenue Service review of its tax exempt status. One of the reasons cited by the IRS in granting the FHCF tax-exempt status is that it is an “integral part of the state” that can exercise state power to collect assessment revenues from lines of insurance that do not receive a direct benefit from the FHCF. Commercial property insurance does not receive reinsurance from the FHCF. Exempting nonassessable commercial property insurance from the FHCF assessment base weakens the ability of the fund to collect assessments as cited in the 1994 IRS decision (IRS Private Letter Ruling 9507307, Nov. 21, 1994) that granted tax-exempt status to the FHCF.

There is no fiscal impact to the Office of Insurance Regulation.

VI. Technical Deficiencies:

None.

VII. Related Issues:

None.

VIII. Additional Information:

A. Committee Substitute – Statement of Substantial Changes:
(Summarizing differences between the Committee Substitute and the prior version of the bill.)

CS/CS by General Government Appropriations on April 22, 2008:

The committee substitute exempts nonassessable commercial property insurance from emergency assessments by the Florida Hurricane Catastrophe Fund.

CS by Banking and Insurance on April 1, 2008:

The committee substitute clarifies that nonassessable commercial property insurance is not subject to a regulatory determination that the rate is excessive, but is subject to a determination that it is inadequate or uses an unlawful rating factor.

The bill also clarifies that an insurer must offer an assessable commercial property insurance policy for sale in order to offer the option on a nonassessable policy.

B. Amendments:

None.