The Florida Senate

Interim Project Summary 2002-119 *September 2001*

Committee on Banking and Insurance Senator Bill Posey, Chairman

ACHIEVING TAX-EXEMPT STATUS AND EFFICIENCIES OF OPERATION FOR FLORIDA'S RESIDUAL MARKET PROPERTY INSURERS

SUMMARY

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 Department of Insurance proposed legislation in 2001 to merge the FWUA and JUA into a single entity, named the Citizens Property Insurance Corporation.

It is recommended that the Legislature consider merger of the FWUA and the JUA into a single, permanent residual market entity. There is no reason to have two residual market insurers providing property insurance coverage. 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.

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 JUA. Legislation may not be necessary if federal legislation is passed that would classify both the FWUA and JUA as tax-exempt entities. 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.

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 more easily by maintaining the types of coverage currently provided -- full coverage in non-FWUA areas and wind only (or hurricane-only) in FWUA areas. 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 in the affected areas.

BACKGROUND

The Florida Windstorm Underwriting Association (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 Florida Residential Property and Casualty Joint Underwriting Association (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. Funding hurricane losses for the FWUA and JUA has been a long-standing concern. 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 to merge the FWUA and JUA into a single entity. The proposal was designed to achieve tax-exempt status for the new entity 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 that would classify both entities as tax-exempt.

Critics of the department proposal argue that little would be gained by merging the two entities and that the issues regarding tax status are not directly related to merger and can be addressed separately, if needed.

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) and the complaint filed in federal district court. The proposed legislation from the department has been analyzed including legal memoranda regarding its potential for obtaining tax-exempt status. Also reviewed, are prior IRS private letter rulings, documentation leading to the IRS opinion regarding the Florida Hurricane Catastrophe Fund, and the Florida Supreme Court opinion that JUA revenues are not subject to the revenue cap.

FINDINGS

Florida Windstorm Underwriting Association (FWUA) - The FWUA sells windstorm and hail coverage in the coastal areas of 29 of Florida's 35 coastal counties. Policyholders must obtain a separate policy from a private insurer to cover non-wind risks.

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 consumer appointed by the Insurance Commissioner, and the department's consumer advocate.

As of July 31, 2001, the FWUA had 424,070 policies insuring $95.5 billion of property value. About 65% of this exposure is in Dade, Broward, and Palm Beach Counties. The FWUA peaked at 499,711 policies in 1998, but its current in-force liability is at an all-time high.

The law expresses 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." If there is a deficit, all authorized Florida property insurers are subject to assessments, based on their market share. Assessments are limited in a given year for losses in that year to 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 of any debt issued to finance the deficit.

The FWUA currently estimates that it faces a 1-in-100-year storm of $4.76 billion. For 2001, the FWUA has $70 million cash on hand and estimates it can collect $502 million in regular assessments against insurers. It can also collect up to $2.47 billion from the Florida Hurricane Catastrophe Fund (FHCF), the state fund from which all property insurers must purchase coverage for a portion of their residential hurricane losses. But, FHCF payments are not triggered until the FWUA pays the first $705 million in losses, plus the FWUA pays a $275 million (10%) co-payment. Funding for these amounts and excess losses is provided by assessments on insurers and debt financing supported by emergency assessments. The FWUA has issued $1.75 billion in "pre-event notes" in order to have funds to promptly pay claims after a hurricane and to reduce the time and expense of post-event financing. The FWUA is paying an average interest rate of 6.92%, using premium and investment income, secured by emergency assessments.

A policyholder is not eligible to continue coverage in the FWUA if an authorized insurer offers to provide windstorm coverage at its approved rates. In 1999-2000, two insurers assumed a total of about 77,000 FWUA policies. Earlier this year, 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, to try to retain their customers. Most of the 58,000 policies have been provided coverage with private insurers other than Atlantic Preferred.

On August 21, 2001, a final order was issued by an administrative law judge, in a suit brought by insurance agent associations, finding that the FWUA is a state agency for purposes of Chapter 120, F.S., and that the take-out procedures are rules that were not adopted in accordance with, and therefore violate, section 120.54. F.S.

The Florida Residential Property and Casualty Joint Underwriting Association (JUA) - 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. 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 Dade, Broward, and Palm Beach Counties. The JUA reached is low point of 59,628 policies in April 2000, but it has averaged about 1,300 net new policies per month since that time, increasing to about 2,600 new policies per month for the last 4 months (April-July, 2001).

The JUA is generally provided the same assessment authority as described for the FWUA, but divided into separate accounts for personal lines residential risks and for commercial residential risks. JUA premiums are required to be the highest 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: (i) $150 million cash on hand (surplus); (ii) $34 million in private reinsurance; (iii) $325 million reimbursement from the Florida Hurricane Catastrophe Fund; (iv) $400 million in regular assessments against insurers; (v) $500 million in pre-event notes (issued in 1997), secured by emergency assessments; and (vi) 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.

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. The Final Report (12/17/96) of the Working Group stated that because of the size of the JUA and anticipated swings in exposure for both the JUA and the FWUA, merging the two entities was not appropriate at that time. However, the Working Group believed that the JUA was a temporary residual market mechanism, and that both boards should work cooperatively toward eventual consolidation. The Report stated, "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. . . .The main benefits of a single entity would be better coordination of management and efficiency in operations. . . .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."

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 savings. The costs of 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.

Merger would also make it easier for the Legislature and regulators to apply consistent policy objectives to the residual market. Amendments over the years have resulted in 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, 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; and (5) provides a different premium base for assessments for each association.

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 expected to be a temporary mechanism. The sharp reduction in JUA policies bears this out to some extent, but its remaining policies and recent growth, and the potential for another market crisis after the next catastrophe argues for 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. It is not generally argued that either the JUA or FWUA 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 residual market is essential to paying hurricane claims.

Merger does not, in itself, address many important policy concerns. Merger 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. Other areas of concern can be addressed, without merger, such as the appropriate representation and selection of board members.

Tax-Exempt Status Valuable, But Not Directly Related to Merger - One of the most important issues 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 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 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 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. Certain factors may lessen the cost-savings from non-taxable securities, such as the limited market for such securities after a hurricane and the "headline risk" of bond investors being reluctant to buy securities associated with a state disaster.

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 JUA may also be achieved through changes to the federal tax laws pursued by the associations. Further, the current law authorizes local governments to issue bonds in conjunction with the JUA or FWUA, payable from assessments, which bonds may be tax-exempt.

Remaining Argument for Merger - Therefore, the argument for merger of the FWUA and JUA rests primarily on the grounds of lower administrative costs, increased efficiencies, and application of consistent policy goals by establishing a single, permanent residual market insurer. This would be an opportune time to implement a merger, given the relative stability of the markets 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. 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 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.

Current Expenses of the FWUA and JUA - 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 servicing carriers to perform these functions, while the JUA staff oversees 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, outside legal counsel, accountants, and financial consultants.

The underwriting expenses in 2000, excluding agent commissions, were $14,166,254 for the FWUA and $13,051,819 for the JUA. But, as a percentage of premium the FWUA expenses were much lower, accounting for 4.19% of premium, compared to 16.92% for the JUA. These are the expenses related to underwriting and investments other than agent commissions, including employee salaries and benefits, service company fees (zero for the FWUA), data processing, legal, audit and professional fees, investment manager fees, underwriting reports, insurance, travel, rent, equipment and supplies. The 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. In 1998, the JUA's expense ratio was only 10.36% of premium, excluding agent commissions, which may be a fairer comparison with the FWUA, because in 1998 the JUA had a much greater premium volume, comparable to the FWUA's premium in 2000. In 1999, the JUA's expense ratio rose to 12.87%, as its gross written premium dropped.

The lower expense ratio for the FWUA indicates that in-house servicing performed by employees is less costly than contracting with service carriers. But, the JUA probably did not have a reasonable option to hire and train employees when it began in 1993 and grew even more rapidly than expected. Policies have dropped dramatically, but this fluctuation tends to make contracting with servicing companies more attractive. The declining premium volume also operates to increase the JUA expense ratio. Certain expenses are fixed costs that do not decline as premiums decrease.

The best opportunity for cost savings if the JUA and FWUA are merged or replaced by a single entity, is by performing in-house servicing with employees. Other savings are likely by reducing costs that are duplicated by two associations, including data processing, equipment, rent, and travel. 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 expense item is agents' commissions, which are established by the boards. For the FWUA, agents' commissions totaled $34.39 million (10.16% of premium) compared to $14.17 million (4.19% of premium) for all other underwriting expenses for 2000 listed above. The JUA paid $5.33 million (6.92% of premium) in agents' commissions in 2000. The FWUA pays a nominal commission of 11% and the JUA pays a 10% commission, but certain past rate increases were not subject to commissions, which substantially accounts for the lower commission expense. 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 commissions paid for the same number of policies and, presumably, the same amount of work. All else being equal, this will increase agent commissions to more than 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 continue to seek tax exempt status from the federal government. In 1999 the JUA formally sought exempt status from the IRS which led to the JUA filing suit in federal court in September 2000, currently pending, claiming a refund for past income taxes paid. Meanwhile, the FWUA and the JUA have jointly lobbied Congress since 1997 to amend the federal tax laws to provide a tax exemption applicable to both associations.

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 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 have been limited to qualifying as tax-exempt entities. However, meeting certain legal criteria could potentially achieve both exemptions.

Three classifications are cited under the federal 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.

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, after extensive negotiations. The IRS ruling cited the: (1) direct operation and control of the Fund by the State Board of Administration; (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 legislation, enacted in 1995, which included a $50 million state appropriation to the Fund; 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.

The JUA filed income tax returns for 1996, 1997, and 1998, and paid a total of $149.9 million in income taxes. In November 1999, the JUA pursued tax-exempt status in the form of a "Technical Advice Submission Request" to the IRS (supplemented in May 2000. The request detailed the JUA's position that it is an "integral part of the state" entitled to tax-exempt status. The JUA cited a federal appellate court ruling that the JUA is a "political subdivision" of the state for purposes of being entitled to immunity from federal anti-trust laws. Also cited were prior IRS private letter rulings which determined that the California Earthquake Fund, the Hawaii Hurricane Relief Fund, and the Florida Hurricane Catastrophe Fund were an "integral part" of their states.

The JUA's argument that it 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 both must be satisfied, based on prior IRS rulings. Elements of state control cited by the JUA included: 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; and state receipt of all remaining assets of the JUA upon dissolution. The financial commitment of the state, as argued by the JUA, includes: 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; and state receipt of the assets of the JUA upon dissolution.

One of the concerns expressed by the IRS involved whether, and how much the State of Florida contributed financially to the JUA. The IRS questioned whether the indirect financial contribution by the state resulting from the tax exemptions resulted in real dollars contributed to the JUA.

Another concern of the IRS is the advisory opinion rendered by the Florida Supreme Court in 1995, which 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 Article VII, Section 1(3), of the Florida Constitution. At that time, the JUA was negotiating its first line of credit and financial institutions were concerned that assessments would be considered "state revenues" limited by the revenue cap provisions. This provision specifically exempts receipts of the Florida Hurricane Catastrophe Fund, but does not address joint underwriting associations. In reaching its opinion, the Court noted the statutory provision that the JUA is not a state agency, board or commission; 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; 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.

Having been unsuccessful in obtaining a favorable ruling from the IRS, the JUA board filed a lawsuit in the U.S. District Court for the 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.

In addition, the FUWA 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 1999 Congress included this provision in its major tax package, but, the legislation was vetoed by President Clinton for reasons unrelated to this provision. This year, efforts continue to pass this legislation, as filed in S. 797 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 others. Several business tax packages are now under consideration which could serve as legislative vehicles to which the provisions could be added. In 1998, the Congressional Joint Committee on Taxation prepared an official estimate of the legislation and concluded that it would reduce federal revenues by $1 million over 10 years, a very small figure for federal budget purposes. It was determined that as taxable entities, the income would be largely offset by tax deductions for claims payments (carried over to profitable years) over the long-term.

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." (Senate Bill 2234 by Senator Garcia; CS by the Committee on Banking and Insurance; withdrawn from the Committee on Governmental Oversight and Productivity; died in the Committee on Finance and Taxation.) The department is expected to propose similar legislation for the 2002 session.

The department's goal is to enable CPIC to issue tax-exempt bonds and to ensure that its income is exempt from federal income taxation. 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." 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 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.

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 that established state control, an essential feature for classification as "an integral part of the State." To provide a significant state financial commitment, the CPIC legislation utilized a premium tax equivalent provision modeled on the California Earthquake Authority, ruled by the IRS to be an integral part of the State. The Authority charges policyholders an amount equal to the premium tax, but is itself exempt from the 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. 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. This was estimated to reduce General Revenue by about $5.25 million.

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 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. After all outstanding debt obligations are satisfied, the bill 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 not assessable in 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 type of the coverage that should be offered by CPIC. Currently, the FWUA writes wind-only coverage in limited areas, and the JUA writes full coverage outside of those areas. The appropriate boundaries of the FWUA involve the issue of encouraging insurers to write windstorm coverage. Insurers are allowed to write non-wind policies in FWUA-areas. But, outside FWUA areas, policies must include windstorm coverage. This provides a greater incentive to an insurer to write the windstorm coverage since that is the only way the insurer is allowed to write the non-wind coverage. As filed, SB 2234 provided that CPIC would offer full residential coverage statewide. This was intended to encourage insurers currently writing non-wind coverage in FWUA areas to pick up the windstorm coverage. Another reason was to provide the consumer with a single policy, rather than separate wind and non-wind policies. But concerns were raised about the impact on the solvency of insurers with a significant amount of non-wind business. Revisions in CS/SB 2234 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. Various 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. It would impose administrative burdens on the Florida Hurricane Catastrophe Fund to determine the appropriate premium and coverage for each insurer and CPIC, because both entities must report exposure data that will have to be reconciled. The concept is intended to result in a single policy to the consumer, but if CPIC and the private insurer are each severally liable for a portion of the hurricane coverage, it may 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 provide the same coverage currently offered by the FWUA and JUA, or to move the current FWUA boundary seaward. One proposal 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.

RECOMMENDATIONS

The JUA was intended to be a temporary solution to a market crisis, but property insurance coverage remains unavailable in south Florida in areas 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 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. 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 underwriting expenses of the FWUA, as a percentage of premium, are 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 JUA. Legislation may not be necessary if federal legislation is passed classifying 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 entity is faced with the additional change to "coinsuring" the hurricane risk with private carriers. Merger could be accomplished more easily, with fewer potential adverse consequences, by maintaining the coverage currently provided -- full coverage in non-FWUA areas and wind-only coverage (or hurricane-only) in FWUA areas. Many complexities are inherent in the coinsurance concept. 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.