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 Banking and Insurance Committee

BILL: CS/SM 2488

INTRODUCER: Banking and Insurance Committee and Senator Posey

SUBJECT: Memorial – Tax Exempt Insurer Reserves to Pay for Future Catastrophic Property Claims

DATE: April 1, 2008 REVISED:

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	Emrich	Deffenbaugh	BI	**Fav/CS**
2.				
3.				
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:

Committee Substitute for Senate Memorial 2488 urges the United States Congress to enact legislation that will allow insurers to establish tax-deferred catastrophe reserves if such reserves are set aside to be used exclusively for paying future property insurance claims arising out of natural catastrophes. The Memorial cites various facts to demonstrate the need for Congress to take action:

- Rising costs resulting from natural disasters place an increased strain on property and casualty insurers to pay homeowners' claims and other insurance claims arising from major natural disasters now and in the future;
- Present tax laws do not provide incentives to ensure that natural disaster insurance is provided or that sufficient funds are available for paying insurance claims in the event of future catastrophic losses from major natural disasters, as current tax law requires an insurer wanting to accumulate surplus assets for this purpose to do so entirely from after-tax retained earnings;
- Revising the tax laws to permit carefully controlled accumulation of pretax dollars in separate reserve funds devoted solely to future hurricane claims' payments will provide an

incentive for insurers to make hurricane insurance available, give greater protection to homeowners and businesses, and help ensure the financial health of insurers; and

- Changing the tax laws will lessen the possibility that the state will have to step in to provide relief at taxpayer expense.

II. Present Situation:

2004 and 2005 Hurricane Seasons

The 2004 and 2005 hurricane seasons were particularly destructive to Florida, with four hurricanes hitting Florida each year. In total, as of August, 2006, insurers reported nearly $36 billion in estimated gross losses in Florida for these eight hurricanes, with claims payments of over $33 billion. The last of these eight hurricanes, Hurricane Wilma, resulted in the greatest total losses in Florida. The losses and claims payments are summarized in the table below.

Hurricane	**Estimated Gross Probable Loss**	**Claim Payments Made**
Charley (2004)	$10.15 bil.	$9.05 bil.
Frances (2004)	7.95 bil.	7.70 bil.
Ivan (2004)	3.31 bil.	3.20 bil.
Jeanne (2004)	3.63 bil.	3.51 bil.
Dennis (2005)	.30 bil.	0.27 bil.
Katrina (2005)	.85 bil.	0.73 bil.
Rita (2005)	0.03 bil.	0.02 bil.
Wilma (2005)	9.66 bil.	8.85 bil.
Total	**$35.90 bil.**	**$33.35 bil.**

Source: Office of Insurance Regulation (OIR), Hurricane Reporting Summaries (August 2006).
Total amounts may not equal the sum of amounts for individual hurricanes due to rounding.

Changing the Tax Treatment of Insurer Reserve Funds for Catastrophes

Florida's recent history of devastating storms has highlighted the fact that our state continues to be subject to weather-related risks such as hurricanes. These hurricanes result in death, property damage, and economic dislocation. The combination of these factors and high private, state and federal costs has generated interest in Congress and elsewhere in proposals designed to change the way private and public entities evaluate and protect themselves against the risk of natural disasters. Given the increasing concentration of insured property values and sophisticated computer models that suggest an increased frequency of hurricanes, there has been some sense of urgency in Congress, state legislatures and the private sector to address the financial exposure to catastrophic risks.[1]

One widely discussed proposal would change the tax treatment of catastrophic risk insurance by permitting insurers to establish tax-deductible reserve funds for catastrophes. This would require amending the U. S. Tax Code, because under the current tax laws and accounting principles, an insurer's contingent reserves for catastrophic events are taxed.[2] Insurers can expense the cost of

[1] *Tax Deductions for Catastrophic Risk Insurance Reserves: Explanation and Economic Analysis*, Congressional Research Service, The Library of Congress, September 2, 2005.
[2] However, there is a federal income tax deduction for losses that have already occurred.

reserves only for losses that have been reported by policyholders but that remain unsettled and losses that are incurred but not reported (IBNR).[3] Insurance representatives state that altering the way in which expected catastrophic losses and income from investments are taxed could expand the availability and lower the cost of hurricane insurance. Tax-deferred reserving would also increase an insurer's capacity to deal with catastrophic risk and provide insurers with an incentive to write catastrophe coverage in hazard-prone areas while improving their own financial strength.[4]

Currently, an insurer that projects a $100 million loss from a hurricane once over the next 100 years (a one-in-100 event) is incurring an expected loss of $1 million annually. The insurer pays taxes each year on the premiums it collects until the hurricane occurs. After the hurricane, the insurer is able to deduct the actual hurricane losses for tax purposes. Arguably, current tax law discourages insurers from setting aside large reserves for future hurricanes. In addition, the taxation of income on capital reserves increases the premiums insurers must charge for hurricane insurance. The federal government could encourage the accumulation of private hurricane reserves by changing the tax code to exempt such reserves from federal income tax.

National Activity Regarding Proposals for Tax Deductible Reserves

In reaction to the losses stemming from the 2004 and 2005 hurricane season, there has been increased interest nationally in creating mechanisms to deal with the insurance consequences of national disasters. The Catastrophe Working Group of the National Association of Insurance Commissioners (NAIC) released draft recommendations in February 2006. The recommendations include modifying the United States Tax Code to encourage private insurers to build catastrophe reserves as well as making available to consumers an all-perils residential insurance policy that would pay for damages to a home (with a higher deductible being available for catastrophic losses). The recommendations also include converting the National Flood Insurance Program to a reinsurance program, expanding disaster mitigation programs for homeowners and establishing a national catastrophe insurance mechanism that would provide reinsurance to state catastrophe funds for insured losses resulting from catastrophic events. In addition to the NAIC, the National Conference of Insurance Legislators (NCOIL) in 2001, adopted a resolution to support a tax-deductible, pre-event natural disaster reserve fund for insurers.

The United States Congress has also begun to investigate ways to address the various difficulties that major hurricanes and other natural catastrophes present. Senators Nelson and Martinez have introduced the Policyholder Disaster Protection Act, s. 926, 110th Cong. (2007), which would

[3] A "property casualty company loss reserve" is an accounting entry, a liability on the balance sheet, for the amount of money the insurer expects to pay out in the future to cover indemnity payments that will come due on policies already written for losses that have already been incurred and the costs of dealing with the associated claims. Loss reserves do not reflect the pattern of future claims payments. Premium payment funds that cannot be put into loss reserves must be treated as underwriting profits.

[4] *Natural Disasters: Public Policy Options for Changing the Federal Role in Natural Catastrophe Insurance,* U. S. Government Accounting Office, November 2007.

allow insurers to establish tax free reserves to pay claims arising from natural disasters.[5] The Act would permit insurers to contribute to Policyholder Disaster Protection Funds, which are capped

based on a multiplier specific to the type of disaster covered by the fund. Furthermore, the bill would require certain annual distributions from the fund.

III. Effect of Proposed Changes:

The bill urges the United States Congress to enact legislation that will allow insurers to establish tax-deferred catastrophe reserves if such reserves are set aside to be used exclusively for paying future property insurance claims arising out of natural catastrophes. The Memorial cites various facts to demonstrate the need for Congress to take action:

- Rising costs resulting from natural disasters place an increased strain on property and casualty insurers to pay homeowners' claims and other insurance claims arising from major natural disasters now and in the future;
- Present tax laws do not provide incentives to ensure that natural disaster insurance is provided or that sufficient funds are available for paying insurance claims in the event of future catastrophic losses from major natural disasters, as current tax law requires an insurer wanting to accumulate surplus assets for this purpose to do so entirely from after-tax retained earnings;
- Revising the tax laws to permit carefully controlled accumulation of pretax dollars in separate reserve funds devoted solely to future hurricane claims' payments will incentivize insurers to make hurricane insurance available, give greater protection to homeowners and businesses, and help ensure the financial health of insurers; and
- Changing the tax laws will lessen the possibility that the state will have to step in to provide relief at taxpayer expense.

The bill resolves that copies of this Memorial be dispatched to the President of the U.S., the U.S. Senate President, the U.S. Speaker of the House of Representatives and to each member of the Florida delegation of the U.S. Congress.

IV. Constitutional Issues:

A. Municipality/County Mandates Restrictions:

None.

B. Public Records/Open Meetings Issues:

None.

C. Trust Funds Restrictions:

None.

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[5] Senators Nelson and Martinez have introduced five other disaster insurance bills which range in scope from establishing a homeowner's protection act and setting up catastrophe savings accounts to providing for reinsurance reform.

V. Fiscal Impact Statement:

A. Tax/Fee Issues:

None.

B. Private Sector Impact:

Changing the tax law to allow insurers to establish tax-deductible reserves would help protect against insurer insolvencies and would increase the availability of catastrophe insurance. It would also enhance the ability of hurricane-stricken areas to recover from disasters and reduce the flow of U.S. capital to offshore foreign reinsurance firms.

C. Government Sector Impact:

Allowing insurers to establish tax-deductible reserves would have the effect of reducing the necessity for the state to provide assistance to hurricane-stricken areas since insurers would be better able to pay their hurricane claims.

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 by Banking and Insurance on April 1, 2008:
Revises that facts which support the need for Congress to enact legislation allowing insurers to establish tax-deferred catastrophe reserves to pay for future property insurance claims arising out of natural catastrophes;
Eliminates governmental entities from establishing tax-deferred reserves.

B. Amendments:

None.