

THE EFFECTS OF A BORDER-ADJUSTED TAX ON FLORIDA'S PROPERTY INSURANCE MARKET

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EXECUTIVE SUMMARY

The U.S. House of Representatives' Tax Reform Task Force recently unveiled its "Blueprint" for comprehensive tax reform, including a proposal to make the federal corporate income tax "border adjustable." The Blueprint does not discuss precisely how the border adjustments would work, so it is unclear whether or how such a mechanism would apply to reinsurance transactions; however, if the tax is applied to such transactions, then it would significantly affect the cost of reinsurance, and, ultimately, property and casualty insurance for consumers. Property insurers rely heavily on foreign reinsurance to diversify low-frequency-high-severity natural catastrophes, so states most vulnerable to catastrophic losses—such as Florida—would be most impacted by applying a border-adjusted tax to reinsurance.

To inform policymakers and taxpayers of the potential impact to Florida, this report analyzes the effects of applying a border-adjusted tax to reinsurance transactions, and estimates the impact of such a tax on Florida's policyholders, the property insurance market, taxpayers, and the economy.

Florida TaxWatch estimates that a 20 percent border-adjusted tax on reinsurance would directly:

- **increase the cost of commercial and residential property insurance in Florida by \$1.4 – \$2.6 billion annually, or \$238 – \$430 per policyholder per year; and**
- **increase homeowner insurance premiums by 7.9% – 12.9% annually.**

Accounting for the indirect effects of the tax on portfolio diversification, Florida TaxWatch estimates that the combined effects of a border-adjusted tax would increase reinsurance rates by 14% – 31%, and thus:

- **increase the cost of commercial and residential property insurance in Florida by up to \$2.4 billion – \$5.5 billion annually, or \$404 – \$910 per policyholder per year; and**
- **increase homeowner insurance premiums by 13.5% – 30.3% annually.**

While these estimates may fluctuate in practice, it is important to note that within the past decade Florida has experienced higher price increases in response to smaller losses of capital than estimated here (e.g., following the 2004-2005 hurricane seasons).

The imposition of a border-adjusted tax would amount to a multi-billion-dollar tax on Floridians, levied on Florida's economic core—i.e. families and businesses, who would pay for the new tax via premium increases and higher deductibles. The effects of this would ripple throughout Florida's economy, negatively impacting jobs, workers' earnings, and economic activity overall.

Florida TaxWatch analysis finds that the direct costs of a border-adjusted tax would have the following impact on Florida's economy:

- Reduce economic activity by \$2.8 billion – \$5.0 billion (GDP);
- Reduce worker earnings by \$1.4 billion – \$2.6 billion; and,
- Reduce employment by 42,841 – 77,402 jobs.

Accounting for the indirect effects of the tax on portfolio diversification, Florida TaxWatch finds that a border-adjusted tax would have the following impact on Florida's economy:

- Reduce economic activity by \$4.7 billion – \$10.5 billion (GDP);
- Reduce worker earnings by \$2.4 billion – \$5.5 billion; and,
- Reduce employment by 72,829 – 163,865 jobs.

Further, since the effects of such a tax would be more pronounced in Florida due to its reliance on foreign reinsurance, a border-adjusted tax on reinsurance would inflict long-term damage on Florida's economy by **increasing the cost of living and doing business, thereby damaging the state's business climate and its economic competitiveness** in relation to other states. This would lead to further job losses and reduced economic activity. Long-term, the interrelated effects of the tax would **cause a decline in business growth and expansion in Florida.**

The cascading effects of a border-adjusted tax on the interrelated property insurance market would further increase the price of both reinsurance and property insurance, and could cause some insurers to offer less coverage in high-risk areas or leave the Florida market altogether, **making it more difficult for Florida families and businesses to afford property insurance.** Additionally, if private insurers will not insure homeowners, the state must step in, which puts taxpayers on the hook. The collective effects of a border-adjusted tax on reinsurance would likely increase reliance on taxpayer-backed insurance entities, which would **significantly increase taxpayers' liabilities and the potential for future tax increases.** The insurance market will try to mitigate these impacts over time; however, due to insurers' reliance on sophisticated offshore reinsurance, it is unlikely that the effects of a border-adjusted tax will ever be fully mitigated.

Considering these negative effects on Florida, and the disproportionate nature of these effects given the concentration of hurricane risk and the need for reinsurance in Florida, federal policymakers should avoid categorizing reinsurance as an import of a service under the proposed border-adjusted tax system and spare Floridians from multi-billion-dollar tax increases and significant negative effects on jobs and economic activity. Indeed, all U.S. trading partners in developed countries that have adopted a similar tax system have exempted reinsurance, together with financial services, which makes reinsurance an area where the playing field is largely level already. While a national border-adjusted tax may benefit the nation as a whole, it should not be paid for disproportionately on the backs of Floridians or Florida's economy, especially when a simple viewing of reinsurance as an exportation of risk, rather than an importation of a service, would accomplish the national goal without unfairly burdening Florida families and businesses.

INTRODUCTION

Recently, the U.S. House of Representatives' Tax Reform Task Force unveiled its "blueprint" for comprehensive tax reform, including a proposal to make the federal corporate income tax "border-adjustable."^{1,2} This proposal may significantly and negatively impact Florida's vital property insurance market, depending on its interpretation and application to the purchase of reinsurance.

To inform policymakers and taxpayers of the potential impact to Florida, this report analyzes the effects of applying a border-adjusted tax to reinsurance transactions. This report estimates the impact of a 20 percent border-adjusted tax on reinsurance on Florida's policyholders, the property insurance market, taxpayers, and the economy. The analysis finds that applying a border-adjusted tax to reinsurance would have significant negative consequences on the affordability and availability of property insurance in Florida.

BACKGROUND

With Florida's exposure to hurricane risk greater than that of any other state, reinsurance is critically important to the health and stability of Florida's property insurance market.

Role & Importance of Reinsurance in the U.S. Property Insurance Market

Reinsurance, often described as insurance for insurance companies, is a crucial risk management tool in the property and casualty insurance industry, particularly for infrequent but high-loss events (aka low-frequency-high-severity) like hurricanes. Reinsurance is widely used by property and casualty insurance companies to mitigate the risk of catastrophic losses.³ Reinsurance allows insurers to share the high costs of a major disaster with reinsurer(s) by sharing ("ceding") some of their exposure to specific risks or concentrations of risk with the reinsurance market, which makes insuring large risks feasible and more affordable.⁴ Reinsurance plays an important role in the availability and affordability of property insurance, especially in high-risk states like Florida.⁵

Reinsurance is a global industry. The international nature of the reinsurance market diversifies geographic exposure to risk, which lowers costs. The majority of U.S. reinsurance is provided by foreign-based reinsurance companies, and in Florida, nearly all private reinsurance is provided by foreign reinsurers.⁶ By spreading risks globally, reinsurance diversifies local insurance markets while providing capital relief and balance sheet protection.⁷

1 House Republicans, "A Better Way: Our Vision for a Confident America", June 24, 2016. Available at: http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf.

2 The border-adjusted corporate income tax reform plan, sometimes known as the border-adjusted import tax (or the destination-based cash-flow tax or the destination-based tax), applies border adjustments to the imports of goods and services to the United States. Throughout this report, we refer to this system as the "border-adjusted tax" or BAT.

3 Nearly all (92%) of U.S. property and casualty insurers reported paying reinsurance premiums between 2004 and 2013. Source: The Federal Reserve Bank of Chicago, "How do property and casualty insurers manage risk? The role of reinsurance", Chicago Fed Letter Number 334 (2015).

4 Federal Insurance Office, U.S. Department of the Treasury, "The Breadth and Scope of the Global Reinsurance Market and the Critical Role Such Market Plays in Supporting Insurance in the United States," December 2014.

5 Reinsurance allows insurers to diversify their risk and reduce the amount of capital they must hold to support those risks, giving insurers the ability to offer more coverage, or provide a higher limit of protection to consumers than its capital assets would otherwise allow. (see, e.g., Federal Insurance Office, U.S. Department of the Treasury, "Report Providing an Assessment of the Current State of the Market for Natural Catastrophe Insurance in the United States", September 2015.)

6 In 2015, 87 percent of private reinsurance to Florida's private residential property insurance market was provided by international (foreign-based) reinsurers, and 32 of the 38 top reinsurers providing coverage in Florida were foreign-based. Similarly, 98 percent of the private reinsurance to Florida's Citizens Property Insurance Corporation (CPIC), was provided by international reinsurers. (Dowling & Partners, IBNR Weekly #15, April 21, 2016, pp. 2, 7, 9.)

7 Ibid.

Border-Adjustment Tax (BAT) Proposal

Republican members of the U.S. House of Representatives, led by Speaker Paul Ryan (R-Wis) and Ways and Means Committee Chair Kevin Brady (R-Texas), have outlined their plans for comprehensive federal tax reform in the Tax Reform Task Force Blueprint (“the Blueprint”), which among other things, seeks to reform the U.S. corporate income tax system.⁸

Under current law, U.S. companies are taxed on their profits (revenues less expenses) at a marginal rate of 35 percent. The Blueprint proposes, among other things, changing the current system by reducing the corporate income tax rate to 20 percent and making the tax “border-adjustable,” which would dramatically restructure how the federal government taxes the earnings of U.S. companies that buy and sell goods and services outside the United States.⁹

The Blueprint does not discuss precisely how the border-adjustments would work, so it is unclear whether or how such a mechanism would apply to financial transactions (as opposed to the importation of goods);¹⁰ however, if the tax is applied to such transactions and specifically to reinsurance, then it would affect the cost of reinsurance and, ultimately, property and casualty insurance for U.S. consumers.

If reinsurance were treated as an import of a service, it would amount to a 20 percent tax on the reinsurance premiums ceded by U.S. insurers to foreign reinsurance companies.^{11,12} Given the reliance of the U.S. property insurance market on foreign reinsurance, such tax policy would significantly increase the cost of insurance, especially in high-risk states like Florida, and affect the property insurance market, taxpayers, and the economy.

Nearly all developed countries (and all developed market trading partners of the U.S.) that levy a value-added tax (VAT) – the most common form of a border-adjusted tax – either exempt financial services or impose a zero percent rate on such transactions.¹³ This is done because, among other things, it is difficult to discern and equitably determine the actual destination of such transactions, which typically have multiple financial flows that move in opposite directions. These bilateral cash flows can occur over many years as underlying losses develop and as frequently complex contract provisions adjust over time.¹⁴ While the imposition of border-adjustments may make sense when applied to the manufacture and sale of goods, its application to financial services, including insurance and reinsurance, is tougher to conceptualize and rationalize.

8 House Republicans, “A Better Way: Our Vision for a Confident America”, June 24, 2016, available at: http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf.

9 A border-adjusted tax is a tax that applies to all domestic consumption (i.e. any goods and services consumed in the U.S.) and excludes all goods and services produced in the U.S., but consumed elsewhere from taxation. The border adjustability mechanism is designed to transform the U.S. corporate tax into a destination-based tax system, meaning taxes would apply based on the location of where goods and services are consumed, rather than where they are produced. This approach seeks to promote U.S. exports by exempting from the new lower corporate tax rate the income from the export of U.S. goods and services, while the cost of importing of goods and services would no longer be a deductible expense of doing business. (The Blueprint, p. 27-29.)

10 At the time of publication, no draft legislation or detailed descriptions of the Blueprint’s proposals have been released since its original publication in June 2016. The Blueprint does not discuss how payments made by U.S. firms to foreign firms would be “border-adjusted”. Although it is unclear how the border-adjustments would work, the Blueprint explains that the intended result is that products, goods, and intangibles exported from the US would be exempt from U.S. income tax while products, goods, and intangibles imported to the U.S. would be subject to the U.S. income tax. (The Blueprint, p. 28.)

11 The amount of premium (fees) used to purchase reinsurance is known as “reinsurance premiums ceded”. (NAIC Glossary of Insurance Terms.)

12 Said another way, a border-adjusted tax that treats reinsurance as an import would effectively result in the denial of the current deduction for reinsurance premiums. When an insurer cedes business to a reinsurer, it is permitted to deduct that amount (“reinsurance premiums ceded”) from its taxable income subject to U.S. corporate income tax. Reinsurance premiums ceded are deductible from corporate income tax as a “necessary business expense” under current federal law.

13 Most governments around the world, including the whole of the European Union (EU), have exempted or zero rated financial services from VAT. (Government Accountability Office (GAO), “Value-Added Taxes: Lessons Learned from Other Countries on Compliance Risks, Administrative Costs, Compliance Burden, and Transition”, April 2008.)

14 Ibid.

Unique Challenges in Florida's Property Insurance Market

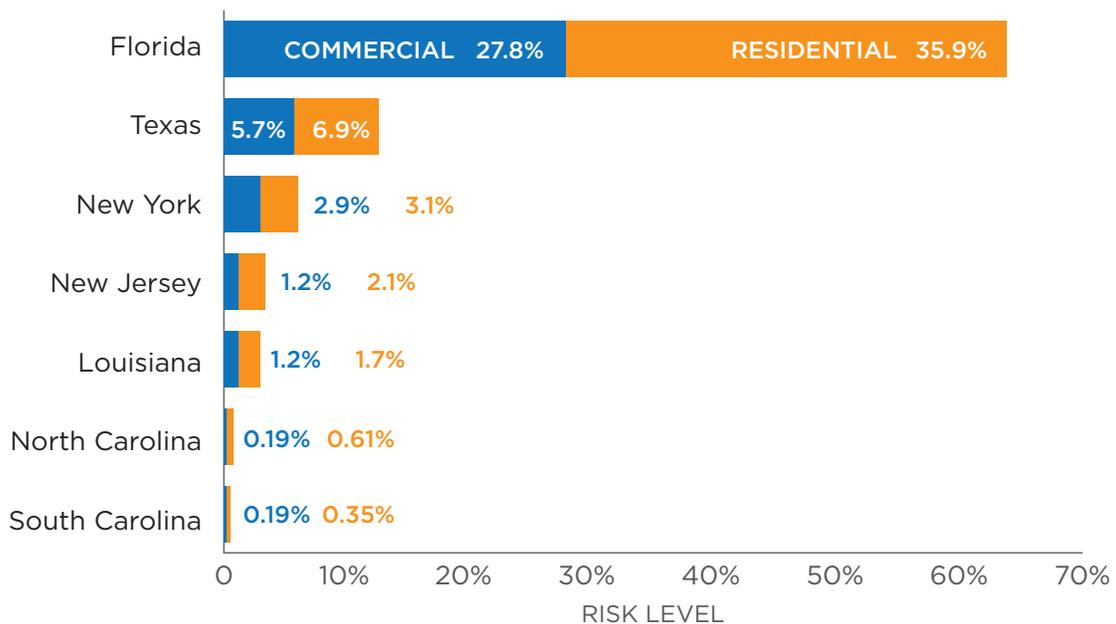
Due to the unique and challenging nature of Florida's property insurance market (hurricane risk, reliance on domestic insurers, and availability and affordability issues), the global reinsurance market is especially important for Florida.¹⁵

Hurricane Risk

As the state with the highest exposure to hurricane risk (i.e., low-frequency-high-severity events), Florida relies heavily on foreign reinsurance to manage it.

According to data from Risk Management Solutions,¹⁶ Florida is home to the highest hurricane risk exposure of any state in the nation, representing a majority of the nation's total risk.¹⁷ Florida is also the home to the world's highest combination of hurricane risk and property values.¹⁸

**FIGURE 1. HURRICANE RISK IN SELECTED STATES (100-YEAR BASIS)
AS SHARE OF U.S. TOTAL**



Source: Risk Management Solutions (RMS) data

¹⁵ Florida property insurers reinsure a significant portion of their premiums, retaining approximately 40% of direct premium written and reinsuring the remainder (The Florida Catastrophic Storm Risk Management Center, Florida State University, "The State of Florida's Property Insurance Market 2nd Annual Report", January 2013). In 2016, 32 of the 38 top reinsurers for Florida's homeowner insurers were foreign. (Dowling & Partners, IBNR #15, April 21, 2016).

¹⁶ Risk Management Solutions (RMS) is a nationally recognized authority on catastrophe risk-modeling. RMS data (2016).

¹⁷ The Brattle Group, "The Impact of Offshore Affiliate Reinsurance Tax Proposals on the U.S. Insurance Market: An Updated Economic Analysis", January 2017, p. 41.

¹⁸ Florida TaxWatch, "Reducing the Concentration of Risk in Florida's Property Insurance System", December 2011.

Reliance on Domestic Insurers

Florida's property insurance market is dominated by relatively small, geographically-focused insurers, which makes the structure of Florida's property insurance market unique among similarly exposed states in terms of the number and market share of domestic insurers.¹⁹ This dependence on small companies with limited capitalization and risk diversification capabilities makes Florida's property insurance market even more reliant on the global reinsurance market and foreign reinsurers than other similarly situated states. To maintain necessary levels of capital required for regulatory purposes, and to satisfy rating agency tests – without which an insurer's coverage does not satisfy federal and state regulations governing conforming mortgages – these companies must maintain robust levels of reinsurance.²⁰ Therefore, these companies have an inelastic demand for reinsurance as they are severely limited in their ability to scale back reinsurance purchases and still meet regulatory requirements.

Insurance Availability & Affordability

Due to its high exposure to catastrophic losses, the availability and affordability of private property insurance in Florida has been a perennial challenge.

Availability continues to be a concern in Florida, especially for certain coastal areas where it remains difficult to obtain coverage in the private market.²¹ Similarly, Florida continues to have the highest average homeowner insurance premiums in the nation,²² which makes the affordability of insurance an ongoing challenge for consumers.

In short, insurers rely heavily on foreign reinsurance to diversify low-frequency-high-severity natural catastrophes, so states most vulnerable to catastrophic losses – such as California, Florida, New York, Louisiana, and Texas – would be most impacted by applying the border-adjusted tax to reinsurance. Still, no state would suffer as much as Florida.

19 Florida Office of Insurance Regulation, "2015 Annual Report of the Office of Insurance Regulation", 2015.; The Florida Catastrophic Storm Risk Management Center, Florida State University, "The State of Florida's Property Insurance Market 2nd Annual Report", January 2013, p. 35 – 38.

20 Federal Insurance Office, U.S. Department of the Treasury, "Report Providing an Assessment of the Current State of the Market for Natural Catastrophe Insurance in the United States", September 2015.

21 See, e.g., Florida Office of Insurance Regulation, "2015 Annual Report of the Office of Insurance Regulation", 2015.

22 ValuePenguin, "Average Cost of Homeowners Insurance (2017)", available at: <https://www.valuepenguin.com/average-cost-of-homeowners-insurance>.

ESTIMATES OF BAT ON FLORIDA POLICYHOLDERS

With no identical alternative to traditional reinsurance available,²³ insurers must purchase reinsurance, regardless of its cost.^{24,25} When reinsurance rates rise, insurers must either pass those increased costs on to policyholders in the form of higher premiums and deductibles, or leave the market. Following the 2004-05 hurricane seasons, for example, Florida insurers continued to buy reinsurance, despite dramatic increases in price. Insurance prices rose dramatically and Florida's residual market exploded.²⁶

This analysis focuses on the effects of a border-adjusted tax in the commercial and residential lines of property insurance in Florida.^{27,28}

The analysis uses multiple years to provide an appropriate sample of data on which to base the cost estimates, specifically 2015 and 2008. These years were selected to account for historic fluctuations in reinsurance prices. In 2015, the reinsurance market cycle was close to its lowest point in 25 years. In 2008, reinsurance prices were higher, albeit not at peak price levels.²⁹

To estimate the reinsurance premiums associated with covering Florida's property insurance market, this analysis uses two approaches to generate a range of estimates.³⁰ The first method uses a 'Bottom Up' approach and the second a 'Top Down' approach to estimate the amount of reinsurance premiums ceded by Florida's property insurance market.³¹

23 Affordable reinsurance is a crucial risk transfer tool that insurers use to spread risk, particularly in catastrophe prone areas like Florida. Replacing reinsurance with an increase in capital isn't feasible, especially for catastrophic risk. Further, many of Florida's insurers are uniquely limited in their ability to raise new capital. Additionally, while alternative reinsurance solutions, such as the catastrophe bond market, have grown significantly in recent years, they are still relatively small when compared to the traditional reinsurance market. Further, most of the alternative reinsurance market is located outside of the United States, and thus, would be subject to a border adjusted import tax as well.

24 Property insurers are subject to regulatory requirements by state and industry regulators to purchase reinsurance protection. The Florida Office of Insurance Regulation requires insurance companies use reinsurance to cover "the totality of the catastrophe risk from multiple storms" in order to sell policies in Florida. (Florida Office of Insurance Regulation, "Informational Memorandum OIR-10-OIM", April 12, 2010.) The Office also actively monitors the risk adjusted solvency of these companies and oversees their reinsurance programs tightly. Further, both insurers and reinsurers are subject to regulatory capital tests and rating agency tests that require specific levels of coverage and protection that are not price elective.

25 Like insurers, many homeowners and businesses are also subject to regulatory requirements, and must purchase property insurance coverage to the satisfaction of state and federal regulators. For instance, homeowners must have insurance to obtain a mortgage. The same is true of commercial real estate lending.

26 Florida Office of Insurance Regulation, "The Homeowners' Insurance Crisis and its Impact on Communities, Homeowners, and the Economy", February 11, 2008.

27 Collectively, the Homeowner Multi-Peril (HMP), Commercial Multi-Peril (CMP), Farmowners Multi-Peril, and non-proportional reinsurance (liability and property) lines of insurance represent the traditional homeowner and business owner property insurance market. According to the National Association of Insurance Commissioners (NAIC), Farmowners Multi-Peril is "similar to a homeowners policy", and therefore is included in this analysis. (NAIC, "Statistical Handbook of Data Available to Insurance Regulators", 2012.)

28 Given that non-proportional reinsurance has become a key input to HMP and CMP, the analysis also includes non-proportional reinsurance (liability and property). Much of the reinsurance for catastrophe risks, including hurricanes, is provided in the two lines of business labeled non-proportional reinsurance (liability and property). Although the National Association of Insurance Commissioners (NAIC) requests that companies report non-proportional reinsurance for HMP and CMP under "Reinsurance: Non-Proportional Assumed Liability," some companies report it under "Reinsurance: Non-Proportional Assumed Property."

29 For more, see: The Insurance Insider, "Reinsurance pricing approaches bottom: analysts", January 17, 2017. Available at: <http://www.insuranceinsider.com/-1264561/17>.

30 Data on reinsurance premiums ceded is only reported nationally and not provided publicly at the state level.

31 Estimates of Florida's share of reinsurance premiums ceded are based on financial data published by the National Association of Insurance Commissioners (NAIC) for U.S. Reinsurance Premiums Ceded. National Association of Insurance Commissioners (NAIC), "Underwriting and Investment Exhibit Part 1B - Premiums Written", Combined Property/ Casualty Insurance Industry Annual Statement, (2015 & 2008).

Bottom Up Approach: Given that Florida’s homeowners insurance market is dominated by small, geographically focused insurers, the ‘Bottom Up’ approach looks at estimates of reinsurance premiums ceded by Florida-only homeowners insurance companies to estimate Florida’s share of total U.S. reinsurance premiums.³² The estimated reinsurance premiums ceded by Florida’s insurance companies, excluding premiums ceded to the mandatory, state-run Florida Hurricane Catastrophe Fund (FHCF), resulted in a 30% estimate for Florida (as a percentage of total U.S. Reinsurance Ceded).³³

Top Down Approach: The ‘Top Down’ approach apportions Florida’s share of total U.S. reinsurance premiums ceded based on its share of the nation’s total earthquake and hurricane risk, which is 45 percent according to data from RMS, a nationally recognized authority on catastrophe risk-modeling.³⁴

As illustrated in Table 1, the amount of reinsurance premiums ceded by Florida’s property insurance market to all reinsurers is estimated to be between \$8.2 billion – \$12.3 billion in 2015 and \$9.9 billion – \$14.8 billion in 2008.³⁵

TABLE 1. FLORIDA’S ESTIMATED SHARE OF U.S. REINSURANCE PREMIUMS CEDED

	U.S. TOTAL REINSURANCE PREMIUM CEDED ^A	SHARE OF REINSURANCE PREMIUM CEDED	FLORIDA SHARE OF U.S. REINSURANCE PREMIUM CEDED TO ALL REINSURERS ^B
2015 Bottom Up estimate	\$27,343,711,000	30%	\$8,203,113,300
2008 Bottom Up estimate	\$32,935,572,011	30%	\$9,880,671,603
2015 Top Down estimate	\$27,343,711,000	45%	\$12,304,669,950
2008 Top Down estimate	\$32,935,572,011	45%	\$14,821,007,405

A: NAIC Data. U.S. Total Reinsurance Premium Ceded includes reinsurance premium ceded in the HMP, CMP, and Non-Proportional Reinsurance (Property & Liability) lines of insurance.

B: Florida TaxWatch analysis.

To estimate “Florida Reinsurance Premiums Ceded to Foreign Reinsurers,” a market share of 87 percent is applied in Table 2 on the next page. Dowling & Partners analysis found that 87 percent of the reinsurance premium ceded by Florida’s homeowners insurance companies in 2015 was ceded to foreign reinsurers.³⁶ A 20 percent tax rate is then applied to that amount to find the direct cost increase of a border-adjusted tax on reinsurance.³⁷ Table 2 then shows the estimated direct cost increase of a border-adjusted tax in Florida.

32 Dowling & Partners, “IBNR Weekly” IBNR #15, Vol. XXIII April 21,2016, p. 4.

33 According to Dowling & Partners analysis, 83% of the Florida-only Residential Property Insurance market paid \$3,330 million in reinsurance premiums in 2015. The remainder (17%) of Florida’s residential reinsurance premiums were purchased from corporate treaties. [Figures do not include cessions to affiliated companies.] To estimate the total reinsurance premiums (100%) ceded by the Florida Residential Reinsurance market, the \$3,330 million is divided by 83% (\$3,330m / 0.83 = \$4,012,048,193). This 100% Florida Residential Reinsurance Premium ceded figure (\$4,012,048,193) was then divided by the NAIC U.S. Total Reinsurance Ceded for Homeowners Multi-Peril insurance in 2015 (\$13,295,936,000), resulting in a 30% estimate (\$4,012,048,193 / \$13,295,936,000 = 30%). Sources: Dowling & Partners IBNR Weekly #15 April 21,2016, p. 4. National Association of Insurance Commissioners (NAIC), “Underwriting and Investment Exhibit Part 1B - Premiums Written”, Combined Property/ Casualty Insurance Industry Annual Statement (2015).

34 According to data from Risk Management Consultants (RMS), Florida’s hurricane risk represents 45 percent of the total hurricane and earthquake risk covered by all states.

35 2008 data is adjusted for inflation (in 2015 dollars) using data from U.S. Bureau of Labor Statistics’ Consumer Price Index (CPI) – All Urban Consumers (Series Id: CUUR0000SAO).

36 Market share data from Dowling & Partners is applied to the estimated amount of reinsurance ceded in Florida for 2015 and 2008. (Dowling & Partners, “IBNR Weekly” IBNR #15, Vol. XXIII April 21,2016, p. 5.)

37 A 20 percent tax rate is applied to the amount of reinsurance premiums ceded to foreign reinsurers because the Blueprint proposes a border-adjustable corporate income tax rate of 20 percent on imported goods and services. (The Blueprint, p. 27-29).

**TABLE 2. REINSURANCE PREMIUM CEDED TO FOREIGN REINSURERS
& DIRECT TAX COST ESTIMATES**

	FLORIDA REINSURANCE PREMIUMS CEDED TO FOREIGN REINSURERS	FLORIDA ESTIMATED DIRECT BAT COST (20%)
2015 Bottom Up estimate	\$7,136,708,571	\$1,427,341,714
2008 Bottom Up estimate	\$8,596,184,295	\$1,719,236,859
2015 Top Down estimate	\$10,705,062,857	\$2,141,012,571
2008 Top Down estimate	\$12,894,276,443	\$2,578,855,289

Direct Border-Adjusted Tax Cost Estimates

The direct cost of a border-adjusted tax on reinsurance premiums is estimated under a static scenario; meaning there would be no change in the behavior of reinsurers. Florida TaxWatch estimates that a 20 percent border-adjusted tax on reinsurance would directly increase costs for Florida property insurers by **\$1.4 billion to \$2.6 billion**, which would amount to an increase of **\$238 to \$430 per policyholder** per year in Florida, assuming nearly six million policies in Florida (see Table 3).³⁸

TABLE 3. SUMMARY OF DIRECT COST INCREASE ESTIMATES IN FLORIDA

	FLORIDA ESTIMATED DIRECT BAT COST (20%)	POLICIES IN FORCE (PIF) ^A	DIRECT COST INCREASE PER POLICYHOLDER
2015 Bottom Up estimate	\$1,427,341,714	5,999,226	\$238
2008 Bottom Up estimate	\$1,719,236,859	5,999,226	\$287
2015 Top Down estimate	\$2,141,012,571	5,999,226	\$357
2008 Top Down estimate	\$2,578,855,289	5,999,226	\$430

A: Data from Florida Office of Insurance Regulation, PIF count for Period Ending 12/31/2015

An alternative way of looking at this would be to apply the same methodology to estimate the change in residential (e.g., homeowners) property insurance premiums. Looking only at homeowner insurance, a 20 percent border-adjusted tax on reinsurance would amount to a **7.9 to 12.9 percent increase in annual homeowners insurance premiums in Florida**.³⁹

These estimates represent the direct impact of a border-adjusted tax on Florida’s property insurance market in a static scenario. In practice, a border-adjusted tax would have further, additive impacts on Florida because it would negatively affect the diversification of reinsurance portfolios and indirectly affect costs.

38 At the end of 2015, the number of commercial and residential property insurance policies in force totaled 5,999,226 in Florida. Data source: Florida Office of Insurance Regulation, “Quarterly Supplemental Report”, Data from Period Ending 12/31/2015.

39 The range for the average homeowner premium increase is calculated by multiplying the U.S. Total Homeowners Multi-Peril (HMP) Reinsurance Premium Ceded (NAIC, 2015) by the Florida share of reinsurance premium ceded (30% & 45%), multiplied by the percentage of reinsurance premium ceded to foreign reinsurers, 87%, multiplied by the 20% tax rate. The estimated border-adjustment tax cost is then divided by the total amount of HMP Premium Written in Florida in 2015 (\$8,772,206,245). Percentage increase (‘bottom up’ approach) = 13,295,936,000 * 30% * 87% * 20% / \$8,772,206,245 = 7.9%. Percentage increase (‘top down’ approach) = 13,295,936,000 * 45% * 87% * 20% / \$8,772,206,245 = 12.9%. Data sources: National Association of Insurance Commissioners (NAIC), “Underwriting and Investment Exhibit Part 1B - Premiums Written”, Combined Property/ Casualty Insurance Industry Annual Statement (2015). NAIC, “State Insurance Regulation in Florida: Key Facts and Market Trends”, 2016 Statistical Report, p. 7. http://naic.org/state_report_cards/report_card_fl.pdf

Indirect Border-Adjusted Cost Estimates

Similar to other segments of the financial marketplace, diversification is the key to efficiently managing capital and reducing cost. A border-adjusted tax would hinder (re)insurers' ability to manage risk by limiting the opportunity to geographically diversify risk throughout the global marketplace. With less geographic risk diversification, risk would be concentrated in one area, leading to a greater need for capital and increased prices for reinsurance.

By discouraging the use of foreign reinsurance, a border-adjusted tax would concentrate risk in the domestic U.S. reinsurance market. With a concentration of risk in one area, the price of *all* reinsurance would go up in order to account for the increased capital needed to support a more concentrated and less diverse risk portfolio. These effects would be most severe for catastrophic exposures, of which Florida hurricane is the most pronounced.

A reinsurer's capital requirements are driven by, among other factors, rating agency and state insurance regulatory capital adequacy requirements. A reinsurer's capacity to deploy capital in the form of reinsurance is strongly influenced by the estimated return on that capital.⁴⁰ Therefore, a decrease in the diversification of a reinsurer's risks will require additional capital and result in an increase in its cost of capital. These dynamics are not necessarily elective because insurers may be unwilling, or not permitted, to purchase protection from reinsurers whose ratings fall below designated levels, and because regulators will curtail a carrier's ability to write new business as the company approaches levels of regulatory capital standards.

To estimate the impact that the anticipated decrease in diversification would have on reinsurers' cost of capital, and subsequently, the price of (re)insurance, Florida TaxWatch simulates three hypothetical reinsurer portfolios, adjusting capital in conformity to the A.M. Best Capital Adequacy Ratio, and assumes that a uniform amount of catastrophe reinsurance premium is written in each portfolio, and U.S. hurricane exposure (the largest exposure in the world by frequency, severity and insured property values)⁴¹ is the largest driver of loss for each.

Two of the three sample portfolios—"50% U.S./50% International" and "75% U.S. /25% International"—represent diversified reinsurers, and the third—"100% U.S."—represents a reinsurer concentrated in the U.S. (in response to border adjustment taxes).

As previously mentioned, under a border-adjusted tax, reinsurers' portfolios would likely become more concentrated in the U.S. As shown in Table 4, this would increase the amount of capital required by reinsurers ('capital requirement') to support the risk ('100 yr U.S. Hurricane Loss'). As a reinsurer's portfolio transitions from a 50% U.S. /50% International portfolio or 75% U.S. /25% International, to a 100% U.S. portfolio, the return on capital decreases significantly, as shown in Table 5. For example, in the case of a 50% U.S./ 50% International portfolio, loss of diversification would have the effect of reducing the return on capital by 50 percent, from 7.5% to 3.75%. Similarly, in the case of a 75% U.S. / 25% International portfolio, diversification loss would result in a 25 percent decrease in the return on capital, from 5.0% to 3.75%.

40 Federal Insurance Office, U.S. Department of the Treasury, "Report Providing an Assessment of the Current State of the Market for Natural Catastrophe Insurance in the United States," September 2015.

41 Ibid.

TABLE 4. RETURN ON CAPITAL BASED ON DIVERSIFICATION OF REINSURANCE PORTFOLIO⁴²

HYPOTHETICAL REINSURER PORTFOLIOS:			
	100% U.S.	75% U.S., 25% INTERNATIONAL	50% U.S., 50% INTERNATIONAL
U.S. Premium	\$274,000,000	\$205,500,000	\$137,000,000
International Premium	\$0	\$68,500,000	\$137,000,000
Premium Total	\$274,000,000	\$274,000,000	\$274,000,000
Expense	\$27,000,000	\$27,000,000	\$27,000,000
U.S. Expected Loss	\$146,385,000	\$109,788,750	\$73,192,500
International Expected Loss	\$0	\$36,596,250	\$73,192,500
Expected Loss Total	\$146,385,000	\$146,385,000	\$146,385,000
100 yr U.S. Hurricane Loss	\$1,089,205,000	\$816,904,000	\$544,603,000
Capital Requirement	\$2,666,667,000	\$2,000,000,000	\$1,333,333,000
Expected Profit	\$100,000,000	\$100,000,000	\$100,000,000
Expected Return on Capital	3.75%	5.00%	7.50%

TABLE 5. CHANGES IN RETURN ON CAPITAL BASED ON DIVERSIFICATION OF A REINSURANCE PORTFOLIO

	EXPECTED RETURN ON CAPITAL AT ORIGINAL PREMIUM
100% U.S.	3.75%
75% U.S., 25% International	5.0%
% Change from 75% U.S./ 25% International to 100% U.S.	-25%
50% U.S., 50% International	7.5%
% Change from 50% U.S./ 50% International to 100% U.S.	-50%

To maintain the same level of portfolio quality and a constant return on capital, reinsurance prices would need to increase to offset the impact of the additional capital required to support a less diversified portfolio. To simulate the impact of diversification loss on reinsurance rates, Florida TaxWatch applied a uniform 5% return on capital to each portfolio (Table 6) and analyzed how the 75% U.S. /25% International and 50% U.S. /50% International portfolios would change as they shift toward the least diversified 100% U.S. portfolio, assuming no change in portfolio quality (Table 7). This analysis finds that **reinsurance rates would need to increase by an estimated 14 percent to 31 percent** to compensate for decreased portfolio diversification under a border-adjusted tax if it is applied to reinsurance.

⁴² Expense is fees paid to brokers, typically a set percentage of total premium. Expenses assumed at 10% of premium total. Expected loss and 100 yr U.S. Hurricane Loss figures from RMS data. Reinsurers' Capital Requirements are based on the 100 year U.S. Hurricane Probably Maximum Loss (PML) estimate since hurricane exposure represents the reinsurer's largest potential loss. Expected Profit (\$) = Premium Total - Expenses - Expected Loss Total. Expected Return on Capital (%) = Expected Profit / Capital Requirement. Figures are based on assumptions and data from RMS for the 75% U.S. / 25% International Portfolio, which were then extrapolated to create the hypothetical 100% U.S. and 50% U.S. / 50% International reinsurer portfolios.

TABLE 6. PREMIUM CHANGES TO MAINTAIN 5% RETURN ON CAPITAL ON A 100% US REINSURANCE PORTFOLIO⁴³

	100% U.S.	75% U.S., 25% INTERNATIONAL	50% U.S., 50% INTERNATIONAL
Expected Loss Total	\$146,385,000	\$146,384,000	\$146,384,000
Capital Requirement	\$2,666,667,000	\$2,000,000,000	\$1,333,333,000
Expected Profit at Original Premium	\$100,000,000	\$100,000,000	\$100,000,000
Expected Profit Needed to maintain 5% Return on Capital	\$133,333,000	\$100,000,000	\$66,667,000
Expected Expense to maintain 5% Return on Capital	\$31,080,000	\$27,376,000	\$23,672,000
New Premium Total	\$310,798,000	\$273,761,000	\$236,724,000

TABLE 7. SUMMARY OF CHANGES UNDER A 100% U.S. PORTFOLIO

	100% U.S.	% INCREASE FROM 75% U.S./ 25% INTERNATIONAL TO 100% U.S.	% INCREASE FROM 50% U.S./ 50% INTERNATIONAL TO 100% U.S.
Capital Requirement	\$2,666,667,000	33%	100%
Expected Profit Needed to maintain 5% Return on Capital	\$133,333,000	33%	100%
Expected Expense to maintain 5% Return on Capital	\$31,080,000	14%	31%
New Premium Total	\$310,798,000	14%	31%

It is important to note that the reinsurers who only write property catastrophe reinsurance from a foreign jurisdiction would experience the largest change in their return on capital. Florida TaxWatch estimates that such reinsurers accounted for 14 percent of the reinsurance premium ceded for Florida homeowners policies in 2015.⁴⁴ This represents an estimated \$4.7 billion of the reinsurance limit for Florida homeowners insurance companies.⁴⁵

Should the border-adjusted tax cause a reduction in the supply of reinsurance provided by these types of reinsurers, the impact on Florida could be significant and severe.⁴⁶ Recent history provides an example of such a scenario. In the wake of the tumultuous 2004-2005 hurricane seasons, billions of dollars quickly moved out of the U.S. reinsurance market, and despite a swift injection of new capital into the market during this time, reinsurance rates increased by 76 percent in 2006.⁴⁷

43 Expected Profit = Capital Requirement * Return on Capital (133,333,000 = \$2,666,667 * 5%). Expense = Premium Total * 10% (\$31,080,000 = \$310,798,000 * 10%).

44 The share of Property Catastrophe-only Reinsurers in Florida is estimated using SNL Financial data based on 2015 NAIC Schedule F financial data for Florida Homeowners Insurance Companies.

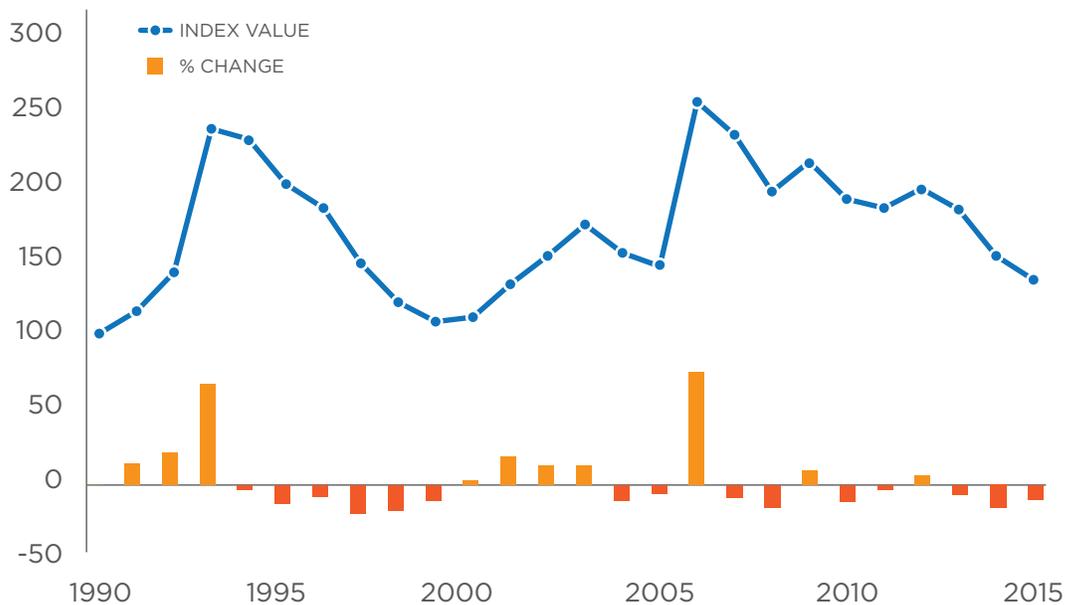
45 The estimated premium amount from property catastrophe-only reinsurers is calculated by multiplying its share of reinsurance premium in 2015 (14%) by the amount of Florida Residential Reinsurance Premium Ceded (\$4,012,048,193) (see footnote 33): 14% * \$4 billion = \$562 million. The estimated limit from property catastrophe-only reinsurers is calculated by dividing the Premium by the Average 2015 Florida Rate-On-Line = \$562 million / 12% = \$4.7 billion.

46 The share of insured losses paid by reinsurers typically increases as the size of the losses mount, a particularly important dynamic for Florida as a result of it being the source of the world's peak insured risk. For example, reinsurers paid out approximately \$30 billion of losses due to multiple hurricanes in 2004-2005; approximately 20%, or \$4.3 billion of the insured losses in 2004, and 45%, or \$25.7 billion, in 2005. (Insurance Information Institute, "Overview & Outlook for the P/C Insurance Industry", May 4, 2007, p. 51-54, 68.)

47 Guy Carpenter and Company, a company that studies the reinsurance marketplace, indicated that reinsurance rates across the U.S. rose by 76% on average in 2006. While this increase was due in part to a reevaluation of the risk by reinsurers and catastrophe modeling companies, a significant portion of the increase was a consequence of the reduction in capital associated with hurricane losses. During this time, property insurance prices rose dramatically and Florida's residual market exploded. See, e.g., Florida Office of Insurance Regulation, "The Homeowners' Insurance Crisis and its Impact on Communities, Homeowners, and the Economy," February 11, 2008.

Figure 2 shows the dramatic change in reinsurance prices during this time. If the market were to react in a similar fashion in response to the border-adjusted tax, there would be significant disruptions in the hurricane reinsurance market and subsequently in the price of property insurance for all Floridians. By looking at how differently the market adjusted to materially changed conditions following events such as Hurricane Andrew (1992), the September 11 tragedy, and the 2004-2005 hurricanes, it's clear that the mechanics of future waves of capital replenishment would be uncertain following the adoption of a border-adjusted tax.

FIGURE 2. U.S. PROPERTY CATASTROPHE RATE-ON-LINE INDEX⁴⁸
(1990-2016)



Combined Direct and Indirect Border-Adjusted Tax Estimates

By shifting their portfolios to the U.S., foreign reinsurers would become subject to the U.S. corporate income tax. As a result, policyholders would not only be faced with the cost of rising reinsurance rates, but also the additional expense of a corporate income tax.

To estimate this indirect impact, this section analyzes how a shift in reinsurer portfolios to the U.S. would affect the cost of property insurance in Florida. While the actual cost increase would depend on the extent to which reinsurers shift their current portfolios to the U.S., this analysis assumes that reinsurers fully shift their portfolios to the U.S. (100% U.S. portfolio) to avoid the border-adjusted tax. Thus, this estimate represents the outer-bound of the potential increase in the cost of insurance.

A 100 percent U.S. reinsurance portfolio would be subject to the U.S. corporate income tax plus the added cost of capital (see Tables 4-7). This analysis assumes a 20 percent corporate income tax rate, as proposed in the Blueprint, and a 14% – 31% increase in reinsurance rates to account for the higher capital costs associated with supporting a less diversified portfolio.⁴⁹

48 Guy Carpenter, "U.S. Property Rate on Line Index," 2016. Available at: <http://www.artemis.bm/indices/us-property-cat-rate-on-line-index.html>.

49 Since the actual makeup of reinsurer portfolios is unknown, reinsurance rates are assumed to increase by 14% – 31% in this estimate. See Table 7.

Florida TaxWatch estimates that should reinsurer portfolios fully shift to the U.S. in response to a border-adjusted tax, it would increase the cost of property insurance in Florida by up to \$2.4 – \$5.5 billion annually, or roughly \$404 – \$910 per policyholder per year (Table 8).

TABLE 8. SUMMARY OF COMBINED ESTIMATES⁵⁰

	2015 BOTTOM UP ESTIMATE	2015 TOP DOWN ESTIMATE
Florida Reinsurance Premium Ceded to Foreign Reinsurers	\$7,136,708,571	\$10,705,062,857
Application of BAT/CIT (20%)	\$1,427,341,714	\$2,141,012,571
14% Increase in Reinsurance Rates	\$999,139,200	\$1,498,708,800
31% Increase in Reinsurance Rates	\$2,212,379,657	\$3,318,569,486
COMBINED COST INCREASE (14%)	\$2,426,480,914	\$3,639,721,371
COMBINED COST INCREASE (31%)	\$3,639,721,371	\$5,459,582,057

Looking only at the impact on homeowners insurance, this would amount to a 13.5% to 30.3% increase in annual homeowner insurance premiums in Florida.⁵¹ The last time the Florida market experienced a diminution in reinsurance capital access of this scale occurred in the aftermath of the 2004 – 2005 hurricane seasons in which insured losses in Florida, though material, aggregated to an amount less than the capacity provided to Florida from reinsurers who currently write property catastrophe reinsurance only from a foreign jurisdiction.⁵² Following this, in 2006, insurance premiums in Florida rose by 20 to 40 percent, doubling in coastal areas, in just one year.⁵³

Similarly, should reinsurance rates go up as result of a border-adjusted tax, insurers will either have to pass those costs on to policyholders, or leave the market. Insurance companies exiting Florida’s property insurance market would decrease consumer choice and competition, leading to further upward pressure on the price of insurance, consistent with prior capacity-constrained market cycles.⁵⁴ While a decade of private market innovation has created a sustainable shift away from these dynamics, limitations on exporting Florida’s risk could return the state’s property insurance market to such a scenario, creating a critical problem for Florida’s homeowners, businesses, and taxpayers.

50 The cost increase is calculated by adding together the proposed 20% BAT on all foreign reinsurance premium ceded in Florida and the estimated cost of reinsurance rate increases (14% & 31%). The estimated tax cost is calculated by multiplying the estimated reinsurance premium ceded in Florida to foreign reinsurers by 20%. Under the Blueprint, the U.S. corporate income tax rate would be established at 20%, the same rate as the BAT. These estimates assume and model taxation immediately subsequent to the implementation of a 20% BAT. Market participants may pursue greater capital efficiency over time, subject to the parameters and uncertainties of the newly adopted tax regime. The estimated reinsurance rate increase cost is calculated by multiplying the estimated reinsurance premium ceded in Florida to foreign reinsurers by the estimated percent increase in reinsurance rates (14% & 31%). For example, 2015 ‘Bottom Up’ approach: (reinsurance ceded to foreigners (\$7,136,708,571) * 20%) + (reinsurance ceded to foreigners (\$7,136,708,571) * 14%) = (\$1,427,341,714 + \$999,139,200) = Combined Tax Cost (\$2,426,480,914). Per policyholder cost calculated by dividing the Combined Tax Cost (\$2,426,480,914) with the number of Policies in Force in Florida (5,999,226) = \$2,426,480,914 / 5,999,226 = \$404 per policyholder.

51 The range for the average homeowner premium increase is calculated by adding together the estimated tax cost and reinsurance rate increase cost, and dividing it by the 2015 HMP Premium Written in Florida. The estimated tax cost is calculated by multiplying the U.S. Total Homeowners Multi-Peril (HMP) Reinsurance Premium Ceded (NAIC, 2015) by the Florida share of reinsurance premium ceded (30% & 45%), multiplied by the percentage of reinsurance premium ceded to foreign reinsurers (87%), multiplied by the 20% tax rate. The estimated reinsurance rate increase cost is calculated by multiplying the U.S. Total HMP Reinsurance Premium Ceded (\$13,295,936,000) by the Florida share of reinsurance premium ceded (30% & 45%), multiplied by the percentage of reinsurance premium ceded to foreign reinsurers (87%), multiplied by the percent increase in reinsurance rates (14% & 31%). The estimated tax cost is added to the estimated reinsurance rate increase cost, and then divided by the total amount of HMP Premium Written in Florida in 2015 (\$8,772,206,245). For example, Percentage Increase (‘bottom up’ approach) = [(((\$13,295,936,000 * 30% * 87%) * 20%) + (((\$13,295,936,000 * 30% * 87%) * 14%))] / \$8,772,206,245 = 13.5%.

52 See footnote 45.

53 Joseph Treaster, “Storm Passes, but Insurance Worries Stay”, New York Times, August 31, 2006.

54 Ibid.

In short, the cascading effects of a border-adjusted tax in the interrelated property insurance market would significantly increase the price of both reinsurance and property insurance, and could cause some insurers to offer less coverage in high-risk areas or leave the Florida market altogether, making it more difficult for Florida families and businesses to afford property insurance. Furthermore, if private insurers will not insure homeowners, the state must step in, which will put taxpayers on the hook.

IMPACT ON TAXPAYERS

By eroding the market conditions conducive to private insurance, a border-adjusted tax could lead to a significant growth of Florida's residual insurance market, namely in taxpayer-backed insurance programs such as Citizens Property Insurance Corporation (CPIC) and the Florida Hurricane Catastrophe Fund (FHCF). As the state's "insurer of last resort," CPIC is required to offer coverage in most cases if no private insurer will offer coverage due to high risk and its intent is to provide affordable policies to those who are otherwise unable to obtain private property insurance.⁵⁵

Growth in the residual insurance market would negatively impact Florida taxpayers by increasing their liabilities and the potential for future tax increases with the financial risk to taxpayers growing in tandem to the size of the residual market.

With nearly \$3 trillion in insured property value in Florida, a growing residual market could dramatically increase the amount of exposure being underwritten by taxpayers.⁵⁶ Concentrating risk in taxpayer-backed property insurance programs increases both the probability and severity of assessments, not only for policyholders, but all homeowners, business owners, auto owners, non-profits, churches, charities, school boards, and local governments – all of which are subject to post-loss assessments in the event of a major storm(s).⁵⁷

Florida finances a significant portion of its catastrophic risk exposure through post-loss assessments.⁵⁸ These assessments are levied on most property and casualty insurance policyholders. If assessments are imposed pursuant to statutory authority, anyone with a property or casualty insurance policy (other than Workers' Compensation and Medical Malpractice policies) would be required to pay these assessments, which could last for as long as 30 years.⁵⁹

In Florida, three taxpayer-backed residual property insurance entities have the power to levy assessments in Florida: CPIC, the FHCF, and the Florida Insurance Guarantee Association (FIGA). All three rely heavily on debt as a source of capital in the event of a major storm. Given a large enough storm, or series of storms, all three entities and the state of Florida would need to issue bonds to pay for hurricane damage.⁶⁰

If residual markets were to grow, Florida could find itself in a similar situation as it was in 2008, when approximately 81% of the probable maximum losses (PML) from a 1-in-50 Year storm would have been financed with taxpayer assessments,⁶¹ effectively increasing the tax burden significantly for nearly all Floridians.

55 Florida TaxWatch, "Risk & Reform: A Florida TaxWatch Analysis of Florida's Property Insurance System", November 2011.

56 AIR Worldwide (2012 data).

57 Florida TaxWatch, "Reducing the Concentration of Risk in Florida's Property Insurance System", December 2011.

58 Post-loss assessments are commonly used by catastrophe-prone states with state-run insurance entities. (Ibid.)

59 The Florida Catastrophic Storm Risk Management Center, Florida State University, "The State of Florida's Property Insurance Market 2nd Annual Report", January 2013.

60 Florida TaxWatch, "Risk & Reform: A Florida TaxWatch Analysis of Florida's Property Insurance System", November 2011.

61 Percentage of FHCF & CPIC losses that would have been financed by post-loss assessments. (The Florida Catastrophic Storm Risk Management Center, Florida State University, "The State of Florida's Property Insurance Market 2nd Annual Report", January 2013, p. 60.)

Florida's Three Taxpayer-Backed Entities

Citizens Property Insurance Corporation (CPIC)

Citizens Property Insurance Corporation (CPIC) is the state's residual market property insurer. CPIC was designed to be the state's "insurer of last resort," providing affordable policies to those who are otherwise unable to obtain private property insurance.⁶² The Florida Legislature requires that CPIC offer coverage in most cases if no private insurer will offer coverage due to high risk,⁶³ thereby requiring CPIC to insure more loss exposure than any private insurer would ever consider.

Unsurprisingly, a high concentration of CPIC policyholders are located in the riskiest parts of the state, where a large storm could cause major losses. In the event of a deficit, CPIC may levy assessments on CPIC policyholders as well as policyholders across nearly all property and casualty insurance lines.⁶⁴

Under a border-adjusted tax, it is likely that CPIC's exposure and high-risk policy count would grow. This would pose a significant financial risk to taxpayers, not only because of the sheer size of its exposure (and potential for high-dollar assessments), but also because of CPIC's unique assessment structure and reliance on foreign reinsurance. When CPIC has a financial deficit in any of its three lines of business (i.e., the Coastal, PLA, and CLA accounts), it has statutory authority to levy up to three different types of assessments. Each line of business calculates its deficit separately, and each has separate assessment authority, which means there is the potential for overlapping assessments caused by deficits in more than one of line of business.⁶⁵ Furthermore, CPIC is heavily reliant on foreign-based reinsurance. In 2015, 98 percent of the CPIC's private reinsurance protection was provided by foreign reinsurers.⁶⁶ Therefore, the current cost of CPIC premiums would likely increase with the imposition of a border adjusted import tax on reinsurance.

Florida Hurricane Catastrophe Fund (FHCF)

The Florida Hurricane Catastrophe Fund (FHCF) was created by the Florida Legislature to provide additional insurance capacity and help stabilize the property insurance market in Florida.⁶⁷ Much like traditional reinsurance, the FHCF pays for a portion of a property insurer's hurricane losses above a certain amount. However, FHCF coverage is mandatory – every residential property insurer in Florida is required to purchase reinsurance from the FHCF and pay a premium.

As with CPIC, the FHCF also relies on foreign reinsurance to reduce its risk in Florida. In 2015, the FHCF completed its first ever private reinsurance purchase of \$1 billion and transferred another \$1 billion of risk to the global reinsurance market in 2016. It is important to note that most of this reinsurance was purchased from foreign reinsurers.⁶⁸ Should this practice continue, the premiums paid by insurers to the FHCF would likely increase under a border adjusted import tax.

62 Florida TaxWatch, "Reducing the Concentration of Risk in Florida's Property Insurance System", December 2011.

63 Ibid.

64 The current assessment base definition for CPIC includes all property and casualty lines of insurance except medical malpractice, accident and health, and workers' compensation. (Citizens Property Insurance Corporation, "Annual Report of Aggregate Net Probable Maximum Losses, Financing Options, and Potential Assessments", February 2016.)

65 For more, see: Florida TaxWatch, "Risk & Reform: A Florida TaxWatch Analysis of Florida's Property Insurance System", November 2011.

66 Dowling & Partners, IBNR Weekly #15, April 21, 2016.

67 Fla. Statutes s. 215.555(1)

68 Florida Hurricane Catastrophe Fund, "Claims-Paying Capacity Estimates", October 18, 2016.; Dowling & Partners, IBNR Weekly #15, April 21, 2016, p.3.

Further, in the event that its (projected) losses exceed its (projected) surplus, the FHCF would likely finance the (projected) shortfall through bonding, and these bonds would be repaid using Emergency Assessments, which are levied on policyholders in almost all lines of property and casualty insurance.⁶⁹ In 2015, a maximum 6 percent Emergency Assessment would have totaled \$2.49 billion.⁷⁰

Florida Insurance Guaranty Association (FIGA)

The Florida Insurance Guaranty Association (FIGA) is a nonprofit corporation created by the Florida Legislature to handle and pay the claims of insolvent property and casualty insurance companies. FIGA may levy assessments on private insurers to cover claims in the event of insolvencies related to major storms. Insurers are allowed to recoup this money from policyholders.⁷¹ If FIGA cannot raise sufficient funds to cover losses from insolvent insurers through assessments, FIGA can combine with a city or county to issue bonds.⁷²

A border-adjusted tax on reinsurance would increase the potential for FIGA assessments because it hinders insurers' ability to raise capital and cover all its claims, which makes it more likely that an insurer would become insolvent in the event of a major storm, thereby triggering FIGA assessments.

Overall Impact

In short, the collective effects of a border-adjusted tax on reinsurance would cause the residual insurance market to grow and increase reliance on taxpayer-backed insurance entities, which would significantly increase the taxpayers' liabilities and the potential for future tax increases in Florida.

69 According to Section 215.555(6)(b)1, Florida Statutes, "(i)f the board determines that the amount of revenue produced under subsection (5) is insufficient to fund the obligations, costs, and expenses of the fund and the corporation, including repayment of revenue bonds and that portion of the debt service coverage not met by reimbursement premiums, the board shall direct the Office of Insurance Regulation to levy, by order, an emergency assessment on direct premiums for all property and casualty lines of business in this state, including property and casualty business of surplus lines insurers regulated under part VIII of chapter 626, but not including any workers' compensation premiums or medical malpractice premiums. Florida Hurricane Catastrophe Fund, "Annual Report of Aggregate Net Probable Maximum Losses, Financing Options, and Potential Assessments", February 2016, p. 8-9.

70 The maximum FHCF assessment is 6 percent of total aggregate premium. Florida Hurricane Catastrophe Fund, "Claims-Paying Capacity Estimates", October 2016. See Appendix B.

71 FIGA can assess private property insurers up to 2 percent of their premium for a Regular Assessment, plus an additional 2 percent for an Emergency Assessment.

72 This has not yet been done, but it is a possibility.

IMPACT ON FLORIDA'S ECONOMY

A border-adjusted tax on reinsurance would significantly, and disproportionately, increase the cost of property insurance in Florida, which would have an impact on all Floridians, not just policyholders.

As previously mentioned, the direct cost of a border-adjusted tax alone could increase the price of property insurance for homeowners and business owners by \$1.4 billion – \$2.6 billion annually. This would amount to a multi-billion-dollar tax on Floridians, levied on Florida’s economic core – families and businesses, who would pay for the new tax via premium increases and higher deductibles.

By significantly increasing the cost of insurance for Florida homeowners and businesses, the proposed border-adjustable import tax reduces the disposable income of homeowners and structurally increases business operating costs, the combined effect of which would ripple throughout Florida’s economy, negatively impacting jobs, workers’ earnings, and economic activity overall.

The tax would dampen consumer spending, business investment, and job creation in Florida. Tax revenue would also decline, placing pressure on critical government programs and services and increasing the potential for future tax increases. A decrease in consumer spending and business investment would impact parts of the economy differently with some likely to suffer more than others (e.g., retail sector, etc.).

Florida TaxWatch analysis⁷³ finds that a \$1.4 billion – \$2.6 billion cost increase (i.e., reduction in household earnings) would have the following economic impact in Florida (see Table 9):

- Reduce economic activity by **\$2.8 billion – \$5.0 billion (GDP)**;
- Reduce worker earnings by **\$1.4 billion – \$2.6 billion**; and,
- Reduce employment by **42,841 – 77,402 jobs**.⁷⁴

TABLE 9. SUMMARY OF ECONOMIC IMPACTS

	FLORIDA ESTIMATED BAT COST (20%)	ECONOMIC IMPACT ON:		
		GDP	EARNINGS	EMPLOYMENT
2015 Bottom Up estimate	\$1,427,341,714	\$(2,749,731,832)	\$(1,427,341,714)	(42,841)
2008 Bottom Up estimate	\$1,719,236,859	\$(3,312,059,243)	\$(1,719,236,859)	(51,602)
2015 Top Down estimate	\$2,141,012,571	\$(4,124,597,748)	\$(2,141,012,571)	(64,261)
2008 Top Down estimate	\$2,578,855,289	\$(4,968,088,865)	\$(2,578,855,289)	(77,402)

Note: Estimates use the U.S. Bureau of Economic Analysis’ (BEA) Regional Input-Output Modeling System (RIMS II, 2015)

73 This analysis uses economic multipliers published by the U.S. Bureau of Economic Analysis (BEA) to calculate the economic impact of the direct tax costs in the state of Florida. (U.S. Bureau of Economic Analysis (BEA), Regional Input-Output Modeling System (RIMS II), 2015. “RIMS II Multipliers (2007/2015) Table 2.5 Total Multipliers for Output, Earnings, Employment, and Value Added by Industry Aggregation. State of Florida (Type II).”) The Regional Input-Output Modeling System (RIMS II) is a regional economic model used to objectively assess potential economic impacts. The impacts are expressed in terms of value added (gross domestic product), earnings, and employment (full- and part-time jobs) on all industries and on individual industries in the local economy.

74 It should be noted that the job losses cited here would not be offset by an increase in reinsurance jobs coming onshore. The reinsurance industry has traditionally had a low headcount, in terms of the number of jobs and people it employs. According to the Insurance Information Institute, there were 25,200 reinsurer jobs in the U.S. in December 2016. Further, overall employment in the reinsurance industry has been falling and is currently at historic lows. (Insurance Information Institute, “Insurance Industry Employment Trends: 1990-2016”, December 2016.)

Looking at the combined effects of a border-adjusted tax, Florida TaxWatch finds that a \$2.4 billion – \$5.5 billion cost increase would have the following impact on Florida’s economy. The economic impact of each scenario in 2015 is presented in Table 10.

- Reduce economic activity by **\$4.7 billion – \$10.5 billion (GDP)**;
- Reduce worker earnings by **\$2.4 billion – \$5.5 billion**; and,
- Reduce employment by **72,829 – 163,865 jobs**.

TABLE 10. SUMMARY OF ECONOMIC IMPACTS

	FLORIDA COMBINED BAT COST	ECONOMIC IMPACT ON:		
		GDP	EARNINGS	EMPLOYMENT
2015 Bottom Up estimate (14%)	\$2,426,480,914	\$(4,674,544,114)	\$(2,426,480,914)	(72,829)
2015 Bottom Up estimate (31%)	\$3,639,721,371	\$(7,011,816,171)	\$(3,639,721,371)	(109,243)
2015 Top Down estimate (14%)	\$3,639,721,371	\$(7,011,816,171)	\$(3,639,721,371)	(109,243)
2015 Top Down estimate (31%)	\$5,459,582,057	\$(10,517,724,257)	\$(5,459,582,057)	(163,865)

Further, since the effects of the tax would be more pronounced in Florida, a border-adjusted tax on reinsurance would inflict long-term damage on Florida’s economy by increasing the cost of living and doing business, damaging the state’s business climate and its economic competitiveness in relation to other states. This would lead to further job losses and reduced economic activity. Long-term, the interrelated effects of the tax would cause a decline in business growth and expansion in Florida.

Some economists suggest that the costs of a border-adjusted tax on imports would be offset by a strong and rapid appreciation of the U.S. dollar.⁷⁵ They argue that the net effects of a border adjustable tax system would lead to a stronger U.S. dollar, which would largely offset the cost of the tax by effectively reducing the price of imports.⁷⁶ However, in the case of reinsurance, this offsetting rationale would not apply. The reinsurance market is largely denominated by the U.S. dollar, and all reinsurance premiums ceded by U.S. insurers to reinsurers are ceded in U.S. dollars.

In short, a border-adjusted tax on reinsurance would significantly, and disproportionately, increase the insurance costs for Floridians, which would reduce consumer spending and business investment in the state. The interrelated economic impacts of the tax could cause long-term damage to the state’s economy by making Florida less attractive and competitive when compared to other states, which could discourage future growth and expansion in the Sunshine State.

75 Alan J. Auerbach, Douglas Holtz-Eakin, “The Role of Border Adjustments in International Taxation”, American Action Forum, November 30, 2016.

76 For more, see Desmond Lachman’s recent article: “Would the GOP’s border tax adjustment lead to a trade war?”, The Hill, January 18, 2017. Available at: <http://thehill.com/blogs/pundits-blog/international/314735-would-the-gops-border-tax-adjustment-lead-to-a-trade-war>.

CONCLUSION

The application of border-adjusted tax to reinsurance would impact all states vulnerable to catastrophic event risk, but with nearly two-thirds of the risk concentrated in Florida, Floridians would be impacted the most financially. These impacts include direct cost increases for policyholders, distortions in the vital property insurance market, increased liability for Florida taxpayers, and a reduction in economic activity – including wages and jobs – in the state.

Applying a border-adjusted tax on reinsurance would significantly increase the cost of property insurance for Florida homeowners and businesses by \$238 – \$910 per policyholder. If federal law categorizes reinsurance as an import of a service rather than an export of risk under the proposed border-adjusted tax system, then Florida will experience between \$1.4 billion – \$2.6 billion, and up to \$5.5 billion, in cost increases and disproportionately bear the cost of federal tax policy changes compared to other states.

Additionally, the effects of these changes on Florida's vital and vulnerable property insurance market are wide-ranging and significant. The cascading effects of the cost increases would simultaneously concentrate risk and constrict supply by potentially causing some insurers to offer less coverage in high-risk areas or leave the Florida market all together, further increasing the price of both reinsurance and property insurance beyond the direct estimate of nearly \$3 billion, and making it more difficult for Florida families and businesses to afford required property insurance.

Collectively, these effects would cause the residual insurance market – i.e., the taxpayer-backed insurance and reinsurance entities – to grow and increase reliance on taxpayer-funded post-event assessments (essentially future tax increases for Floridians).

Overall, these direct and indirect effects would significantly, and disproportionately, increase the insurance costs for Floridians, which would reduce consumer spending and business investment in the state. The interrelated economic impacts of the tax could cause long-term damage to the state's economy by making Florida less attractive and competitive when compared to other states, which could discourage future growth and expansion in the Sunshine State.

Considering these negative effects on Florida, and the disproportionate nature of these effects given the concentration of hurricane risk and the need for reinsurance in Florida, where nearly two-thirds of the nation's total hurricane risk resides, policymakers should avoid categorizing reinsurance as an import of a service under the proposed border-adjusted tax system and spare Floridians from multi-billion tax increases and significant negative effects on jobs and economic activity. While a national border-adjusted tax may benefit the nation as a whole, it should not be paid for disproportionately on the backs of Floridians or Florida's economy, especially when a simple viewing of reinsurance as an exportation of risk, rather than an importation of a service, would accomplish the national goal without unfairly burdening Florida families and businesses.

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