

## MEMORANDUM

**TO: Bob Ricker**

**FROM: John Forney**

**RE: Combining Citizens' Accounts**

**DATE: January 13, 2006**

### Background

Citizens was created in 2002 via a merger of Florida's two insurers of last resort, the Florida Windstorm Underwriting Association (FWUA) and the Florida Residential Property and Casualty Joint Underwriting Association (JUA). The technical mechanism used to effect the merger was to rename the JUA Citizens and to transfer the assets of the FWUA to the new entity. The merger allowed Citizens to become exempt from all federal taxes, resulting in millions of dollars in annual savings. Citizens was also designed to realize administrative and economic efficiencies over its predecessor organizations.

At the time of the merger, both the JUA and the FWUA had outstanding long-term debt obligations. Partly in recognition of the legal and financial restrictions surrounding that debt, Citizens was created with three separate accounts:

- 1) **Personal Lines Account (PLA) - Multi-peril policies**
  - a) Consists of the personal lines of the JUA -- homeowners, mobile homeowners, dwelling fire, tenants, condominium unit owners and similar policies.
- 2) **Commercial Lines Account (CLA) - Multi-peril policies**
  - a) Consists of the commercial lines of the JUA -- condominium association, apartment building and homeowner's association policies.
- 3) **High-Risk Account (HRA) – Wind-only policies**
  - a) Consists of all business formerly written by the FWUA -- personal lines wind-only policies, commercial residential wind-only policies and commercial non-residential wind only policies issued in eligible areas.

**Each of these accounts is a separate statutory account and therefore has separate calculations of surplus, plan year deficit and assessment base. By statute, assets may not be commingled or used to fund losses in another account.**

Recently it has been suggested that Citizens should explore the possibility of combining these accounts. The purpose of this memo is to provide a broad overview of the main advantages and disadvantages of this course of action from both a theoretical and practical standpoint.

**RAYMOND JAMES**

## Analysis of Combining the Accounts

### The Biggest Practical Benefit --- Reduced Assessments?

The most oft-cited reason for considering combining the accounts is that it could reduce the overall amount of Citizens-related assessments faced by Floridians. The situation in 2004 in Florida is the most obvious example in support of that argument. In that year, the HRA ended the year with a \$515 million deficit, for which a 6.8% assessment was levied in August 2005. The PLA and the CLA, however, ended 2004 with surpluses of approximately \$162 million and \$25 million, respectively. If this combined surplus could have been used to offset the HRA deficit, the aggregate Citizens deficit would have been reduced by \$187 million to \$328 million, and the assessment would have been reduced accordingly.

However, to be fully considered, this argument must be followed through to subsequent years. For example, if the accounts had been combined in 2004, Citizens as a whole would have entered 2005 with no carry-over surplus. With the accounts separated, the \$187 million in combined year-end 2004 PLA/CLA surplus carried over to 2005. Given the losses associated with the storms in 2005, this would have made a difference in the total assessments likely to be faced by Floridians. (The numbers in the following paragraph are based on estimates, and may vary significantly depending on total ultimate losses associated with Hurricane Wilma).

**2005 Example:** With the accounts separate, the PLA and CLA should be able to use their operating income, carryover surplus, FHCF recoveries, and private reinsurance coverage to have no plan year deficit for 2005. The HRA, however, may have a plan year deficit for 2005 of approximately \$1.3 billion, all of which would need to be recovered in assessments. If the accounts had been combined (and therefore with no carryover PLA/CLA surplus), the total deficit for 2005 almost certainly would be higher, since the PLA and CLA suffered hurricane losses totaling approximately \$300 million in 2005, and had budgeted underwriting income of only about \$116 million to offset that. Without the carryover surplus, and assuming the same levels of FHCF and private reinsurance recoveries, there would be a combined deficit of approximately \$100 million in these accounts for 2005, in addition to the \$1.3 billion HRA deficit. This additional deficit would partially offset the benefit received in 2004, so that for the two years 2004-2005, there would have been a net reduction of approximately \$87 million in the total assessments if the accounts had been combined.

One important note here is that this assumes the same level of FHCF and private reinsurance coverage in either case --- in reality if the accounts were combined, different decisions would likely have been made with regard to private reinsurance coverage, which may have altered the numbers above somewhat. **However, I believe that, given the characteristics of the three accounts, combining the accounts would on average reduce overall Citizens-related assessments.**

### The Biggest Practical Drawback --- the Costs

Any benefits from potential reduced assessments must be weighed against the very real costs of achieving the combination. These costs are primarily due to the provisions surrounding the existing indebtedness of the three accounts. In order to combine the security structure and allow one account to pay for losses in another, the terms of that debt must be amended. To accomplish this, either the consent of a majority of bondholders must be obtained or the outstanding debt must be retired or defeased. Practical difficulties with regard to locating and obtaining permission of bondholders for certain of the outstanding debt (specifically the 1997 FWUA Notes) make the amendment process uncertain at best. Retiring or defeasing all the debt is possible, but comes with a stiff price tag, primarily due to the structure of the redemption provisions for the 1999 HRA Notes. These bonds have a so-called “make-whole” call provision that is designed to protect bondholders from having their bonds called in a low interest rate environment when finding a replacement investment at comparable rates would be impossible. These make-whole provisions require Citizens to pay bondholders a large call premium if the bonds are retired early (their stated final maturity is 2019) and interest rates at the time the bonds are retired are less than the fixed rate on the bonds (7.125%). In current market conditions, that call premium would be approximately \$200 million. These and other costs associated with the refinancing of Citizens’ debt must be explicitly weighed against the potential benefits of combining the accounts.

Two other considerations in this regard: (1) Timing. The 1997 Notes mature in 2007, so at that point only the permission of the 1999 and 2004 bondholders would need to be obtained to combine the accounts (without having to do the redemption and pay the make-whole call.) Since these bonds are insured, the insurers have the legal right to consent to such amendments. This removes one large practical difficulty and may make it possible to combine the accounts by amendment in 2007 without retiring the 1999 Notes (although there are other compelling financial reasons to consider retiring these notes regardless of whether the accounts are combined or not); (2) Current Refinancing Opportunities. The losses caused by the 2005 storms may have created an opportunity for Citizens to refinance the 1999 Notes and save money even after considering the payment of the make-whole call premium. This is because post-event bonds can be issued at lower tax-exempt rates, while the 1999 Notes (and all of Citizens other outstanding pre-event debt) were issued with higher taxable interest rates. If this refinancing can be accomplished, one significant obstacle to the account combination would be removed this year.

### Other Considerations

Other arguments both for and against the consolidation of accounts include the following;

(1) Combining the accounts provides diversity to Citizens portfolio. Citizens’ HRA has large geographic and event concentration that would never be accepted by voluntary insurers. Combining it with the PLA and CLA, which have more geographic dispersal and greater financial stability and predictability since they cover all perils,

would help reduce Citizens' overall risk profile. This is the intuitive reason why I believe required assessments would be lower under a combined account structure.

(2) Combining the accounts may reduce Citizens' assessment resources. As currently configured, each of the three accounts has 10% Regular Assessment authority and 10% annual Emergency Assessment authority to pay for its respective deficit. Combining the entities may reduce the dollar amount of this overall assessment ability which could negatively impact the credit of Citizens and its cost of capital.

(3) On the other hand, capital costs may decrease slightly overall, since the largest user of capital (the HRA) would benefit from the stronger credit of the PLA/CLA. The combined entity may therefore have slightly reduced overall borrowing costs, which would again tend to reduce assessments.

(4) It's Hard to Do. The combination of Citizens' accounts would require legislative action and a significant commitment of resources by Citizens' staff and advisors to structure and execute the most efficient consolidation plan. These commitments should not be underestimated.

### **Conclusion**

If Citizens were being structured from the ground up, with no pre-existing financial or legal obligations, I believe the combined account structure would be the preferred alternative. In the long run, I believe it still is, even considering the practical difficulties and costs associated with the process in light of the existing constraints. Although mid-2007 is probably the earliest that all steps of the plan could be executed, it is worth beginning the planning process now.