Consumer Federation of America
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TESTIMONY OF
J. ROBERT HUNTER[1], DIRECTOR OF INSURANCE
BEFORE THE OFFICE OF INSURANCE REGULATION
PRAETORIAN INSURANCE
JULY 3, 2012

Mr. Commissioner and members of the Office, I appreciate the opportunity to speak to you this morning. The work you are undertaking to address the abuses in force-placed insurance (FPI) is of vital importance to Floridians, many of whom are being harmed today. Your hearing on Praetorian rates also offers hope to consumers who have paid excessive rates for force-placed coverage throughout Florida.

As you will see in Appendix 1, I believe that Praetorian rates should be lowered by at least 44.1 percent and, since I only could review part of the filing as certain documents were unavailable as "trade secrets" and the actual loss ratio experienced by the insurers is around 5 percent, most likely the rates should go down much more than that.

Background

Force-placed insurance (FPI) is an insurance policy placed by a lending institution on a borrower's property, when a borrower does not keep his or her hazard insurance in force. The lender is typically the named insured party. The borrower is also usually listed as an "insured" on a force-ordered (FO) policy. The majority of FPI policies are issued when the borrower loses normal insurance due to non-payment of premium.

Lenders use FO insurance to assure continuous coverage on properties. In some instances, lenders use FO insurance as a profit center by collecting commissions from insurers through lender-affiliated agents or brokers or by receiving below-cost or free services (such as tracking of loans) from insurers, and/or using "fronting" primary insurers to direct the coverage to lender-affiliated captive reinsurers. Lenders often receive free or below cost services from affiliated service providers.

Due to of the recent tough economic and housing situation, many more policies have become force-placed. The data on Balboa homes insured shows 3,598 homes insured in 2005 and 319,926 homes insured in 2010.

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A major problem with the use of FPI insurance is "reverse competition." Reverse competition is a market structure in which insurers compete for the lenders' business by providing financial considerations to the lender, including commissions, subsidized services, and other things of value. These expenses are included in the premiums charged to borrowers, which significantly drives up the price. In other words, reverse competition is a market condition that drives up prices to the consumers, as opposed to normal competition, which drives down prices to consumers. Market forces do not discipline insurers to remove unreasonable expenses when reverse competition exists.

Normal competition exists when the purchaser of insurance is the insured party who pays for the coverage. He or she therefore shops for the lowest possible price. The competition is reversed when the “buyer” (lender) is not the ultimate payer of the premium but, instead, has a financial interest in the insurance through commissions or other financial benefits. In this case, the lender, who is not the ultimate payer, has an incentive to seek higher cost insurers that offer bigger kickbacks and benefits, rather than the lowest cost option. This financial incentive may explain why low-cost options for force-ordered borrowers -- such as establishing an escrow account and paying the voluntary premium, in the case of non-escrowed insureds being terminated for non-payment -- does not appear to be a high priority for lenders.

FPI Rates are Excessive

Reverse competition manifests itself in FPI through the payment of commissions to agents or brokers affiliated with the lender or servicer, the provision of below-cost or free tracking services provided by the FPI insurer to the lender, and through FPI carriers that reinsure FPI insurance (either in whole or in part) with captive reinsurers owned by lenders. Thus, FPI rates are much higher than normal insurance rates.

Data demonstrating the excessiveness of FPI prices for Praetorian is shown in our analysis of their May 4, 2012 rate filing (See Appendix 1)

Reverse competition abuses fall into the cracks between insurance and banking regulation. Looked at purely from the typical insurance regulator’s perspective over recent decades, FPI is commercial insurance between a sophisticated seller (the FPI insurance company) and a sophisticated buyer (the lender or servicer.) In addition, the expenses that occur because of reverse competition may be unjustifiably high, but they are real. Commissions really are paid to agents, below-cost tracking costs can be documented and reinsurance arrangements with lender affiliates do exist.

Insurance regulators have looked at these facts and have usually approved the rates to be charged *to the lender*. However, until recently, insurance regulators did only a superficial analysis to see where those expenses were flowing. This analysis uncovered a hidden rebate to the named insured party, such as a lender. Overt rebates such as these are illegal in Florida and almost every other state.

Further, insurance regulators did not look beyond the insurer/buyer transaction to assess the impact on others who might be actually paying the bill, such as the borrowers who pay for

FPI. This lack of attention to consumer impact is also true for automobile FPI, title insurance and various forms of credit insurance, where reverse competition is rampant. Individual consumers are significantly harmed by these cozy reverse competition arrangements.

Banking regulators appear to have done little to control these abuses either. They often see this as an insurance issue; in other words, somebody else's problem. Besides, what could be better for safety and soundness than the huge profits FPI generates?

Insurer/Servicer Explanations for High Rates are not Valid

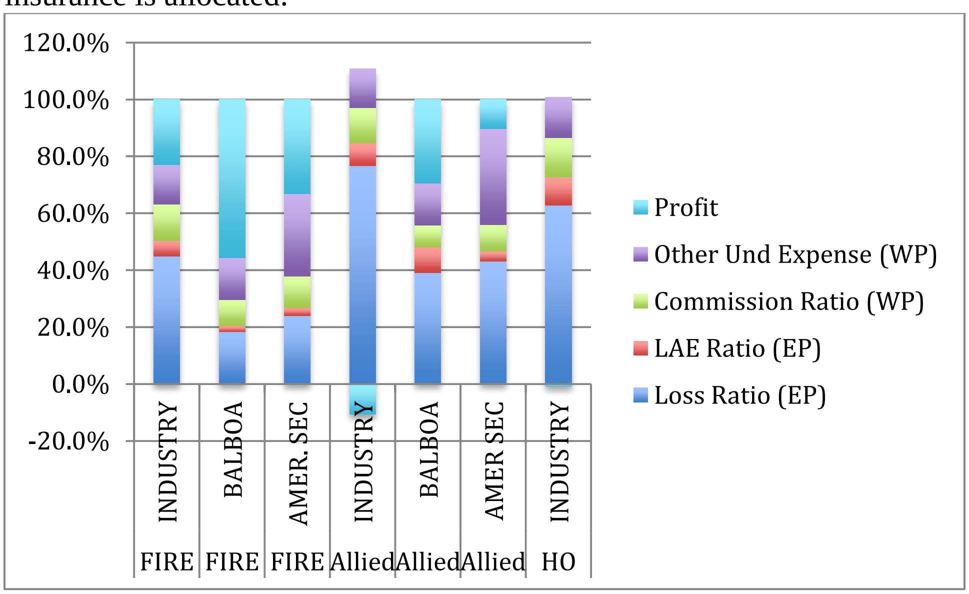
Insurers have justified excessive FPI rates on two basic grounds:

1. Insurers do not underwrite FPI, and, therefore, cannot adequately consider the insurance risk of each borrower, and

2. Insurance departments approve all FPI rates.

Data demonstrates that the lack of underwriting only explains, at most, a small fraction of the higher FPI prices. Some borrowers do not have home insurance – and must be force placed – because they are higher risk and cannot get the coverage. However, most of borrowers who are force-placed are there because of non-payment of premium, not higher insurance risk.

Consider this chart showing how each premium dollar for FPI and normal home insurance is allocated:



Data underlying this chart are shown in Appendix 2. "HO" is Homeowners Insurance.

Note that the loss ratios (the part of the dollar used up by losses) are much lower for Balboa and American Security, which sell FPI, than for the home insurance industry overall. If an insured can't pay his or her homeowner's insurance premium and is thus force-placed, the expected payouts in losses per-dollar-of-premium drops sharply from 62.7 percent for the average industry homeowners' policy to 24.0 percent for American Security and 18.3 percent for Balboa.

To put these ratios into perspective, if a homeowner being force-placed was paying a rate of $1,000 for the average industry homeowners' policy, the insured's expected losses would be $627.00. However, in order to cover $627.00 for claims payouts, American Security would require a premium of $2,612.50 and Balboa would require $3,426.23, rather than the average industry homeowner's policy charge of $1,000 to cover that payout.

Lack of underwriting should also result in much lower acquisition expenses for FPI insurers, since no sales force is required to place the insurance. For this and other reasons, it is unclear if overall FPI rates should legitimately be much different than normal rates, when adjusted to use proper commissions (if any at all are justified), to remove unjustified tracking costs from pricing and to eliminate profit kickbacks through captive reinsurance arrangements. I expect it they would be only marginally higher if they were properly priced.

Approval of rates charged by a FPI insurer to lenders by Florida should not be seen as approval of what lenders can charge borrowers. This is because borrowers should not have to pay for expenses that are not related to the insurance risk being covered for that individual. For example, the 2 percent of borrowers who are force-placed pay all or much of the cost of tracking 100 percent of the portfolio of lender loans, including escrowed loans that will not be force-placed for non-payment. Further, expenses that are clearly excessive, such as the commissions paid for many force-placed policies, should be controlled. Likewise excessive profits for bank-affiliated reinsurers should be eliminated. In other words, FPI profits flowing to the lender should be excluded from the price charged to the borrowers for FPI. The amount a borrower pays for FPI should be only that which is reasonably necessary to cover the risk, expenses and profit of that individual's insurance.

Suggestions for Reform

Use escrow to keep voluntary coverage in place. In cases of non-payment leading to a need for coverage to protect the collateral, lenders should use the escrow (or set up escrow if it is not in place) to pay the original carrier and thus continue the voluntary policy in force. This recommendation should be brought to the attention of Florida's Office of Financial Regulation.

Eliminate or substantially reduce kickbacks. I recommend requiring a minimum loss ratio (MLR) as the best way to control the adverse consequences to consumers of reverse competition. However, to be meaningful, the MLR must be vigorously enforced. The loss ratios that insurers claimed they would meet in earlier rate filings were never realized. Indeed, as demonstrated above, the actual loss ratio results were often less than half of what the insurers said they would be (see Appendix 2).

Commissions to lender-affiliated agents or brokers are problematic and appear to be falling out of use, as some lenders have recently eliminated them. There is little for an agent or broker to do in a force-placed situation and little need for commissions. Realistically, a fair commission for FPI insurance is well under 2 percent, using industry norms and considering the higher price of FPI. Even if FPI rates come down to the proper level -- a fraction of today's rates -- it is unlikely that the fair commission rate would reach 3 to 5 percent of premiums. Other acquisition and general expenses should also be minimal; perhaps another 5 percent when tracking costs are not included. A minimum loss ratio of no less than 80 percent seems reasonable as an enforceable standard, in order to remove the adverse effects of reverse competition from FPI insurance.

The alternative approach is to allow only reasonable expenses associated with the provision of FPI insurance and prohibit expenses associated with servicing and profits that flow to lenders. Given the existence of reverse competition and the history of low loss ratios and inflated expenses, the burden should be on insurers to demonstrate the legitimacy and reasonableness of expenses. However, this standard is much more difficult to enforce than a MLR, since it requires the OIR to continually dig beneath expenses and profits to find out where these dollars are flowing. It is possible to do, but very complex. Moreover, it is not a very effective way of countering the reverse competition dynamic that is prevalent in this market place.

If a MLR is not adopted and enforced, then I urge the department to demand <u>immediate rate filings</u> for all FPI insurance rates and do a complete statistical and actuarial analysis of these filings. I am very pleased that this hearing has been called on Praetorian's FPI pricing. Your market conduct examiners, actuaries and other experts will have to, for the first time, delve beneath the surface of expenses and affiliate arrangements, such as reinsurance, to determine fair levels of expenses and profits and root out the vestiges of reverse competition abuses.

<u>Praetorian Rate Filing</u>

I analyzed the part of the Praetorian filing that was made publicly available – see Appendix 1. The insurer provided data for 2007 to 2010 that showed a loss ratio in Florida of only 4.4 percent, yet, they propose no reduction in rates! The insurer proposal to keep Balboa rates unchanged should be rejected. Instead, rates should be lowered by at least 44.1 when the "trade secret" filing and other factors we highlight in Appendix 1 are reviewed. Unfortunately, CFA was unable to review the "trade secret" material at this time

<u>Conclusion</u>

Mr. Commissioner, I congratulate you and the department for your groundbreaking work to highlight and reform abusive FPI practices that harm millions of consumers. Your actions in this matter will help set the stage for needed reform not only here in Florida but across the nation.

<u>Appendices</u>

1. Analysis of current FPI rate filings by Praetorian.
2. Insurance statistics for FPI and voluntary home insurance for the last decade.

APPENDIX 1

REVIEW OF FLORIDA RATE FILING OF PRAETORIAN INSURANCE COMPANY (BALBOA AND QBE Specialty)

Praetorian made a force-placed insurance rate filing on May 4, 2012. In it, the insurer proposed to charge Balboa's existing rates for both Balboa and QBE. The proposed rates would allegedly represent no change from the Balboa level, while allegedly reducing QBE Specialty insurance rates. The filing claims QBE Specialty rates are 10.5 percent higher than Balboa's, but no support is provided for this claim. For most exhibits, combined QBE Specialty and Balboa experience is provided; the data should be provided separately to evaluate the impact of combining the books of business.

It should be noted that QBE Specialty is a surplus lines carrier. It is unclear how the agent affiliated with QBE Specialty could have complied or can comply today with surplus lines due diligence requirements when other admitted insurers are writing this coverage.

The filing could only be partially reviewed by CFA, since all material related to hurricane CAT pricing, including the charge for reinsurance, is not available to the public because the filer claimed this information as a "trade secret." Partial availability of the data upon which a rate filing is based is a disservice to the people of Florida. I recommend changing this practice so that interested parties can see the entire case made by insurers for the rates that Floridians must pay.

Using the available material, as discussed below, CFA finds that the rate filing is a massive actuarial overreach. Even assuming that the information provided by the company on hurricane CAT pricing is 100 percent valid, I calculate that prices should drop by at least 44.1 percent and most likely a lot more than that. I recommend that you deny the insurer's request to continue using the Balboa rate levels and act to bring rates down to a reasonable, not excessive level.

Consider this: the actual 2Q 2007 to 2Q 2011 incurred losses and loss adjustment expense (LAE) was $62,375,524 and the actual earned premium was $1,399,464,459. This represents a loss ratio of 4.5 percent, which means that less than 5 cents out of every dollar paid in premium went to claimants!

How can a rate filing based on such low payouts conclude that no change in price is needed? It can be done because, as one former insurance commissioner put it, "A rate filing is a few facts and a lot of factors." By applying questionable factors, Praetorian attempts to mislead you, Mr. Commissioner. By not asking for change, their distorted calculations indicate a rate decrease of 15.5 percent, which may be akin to Brer Rabbit asking to be tossed into the Briar Patch. Praetorian would probably love to receive only a 15.5 percent decrease.
The data used in the filing should be reviewed. Data on REO business should be excluded in the calculation of rates to be charged to borrowers. Borrowers should not be required to subsidize

bank REO properties. Further, the data should be split between Balboa and QBE to see if the indications are different since QBE's recent entry into the market might skew the combined data.

Let's catalogue the impact of Praetorian's use of improper factors:

Expense Provisions

Praetorian selected expense provisions (other than hurricane CAT costs) totaling 34.9 percent of premium. They based this number on 15.0 percent paid in commissions, even though, historically, they spent only 4.7 percent on commissions. They also asked for more than they spent on general expense (11.5 percent vs. 9.4 percent). Logically, force-placed insurers incur very low expenses for generating business, since the tracking of the loan delivers the business to the insurer at no cost. So, commissions and other acquisition costs should be well under 5 percent of premium. (CFA allows 5 percent in the rate level calculation below). Praetorian says it needs to jack up commissions because of "expected commissions necessary to acquire new business commensurate with industry standards." What that means is the industry has, up-to-now, paid kickbacks to bank-affiliated agents and the insurer can't compete if they do not do the same. This is exactly what your regulatory oversight must stop.

The large amount of general expenses that Praetorian claims is another kickback area. The cost of tracking loans has been done for free or below-cost by force-placed insurers. These tracking costs in addition to commissions are hopefully ending as a result of the recent decisions by Fannie Mae.

I assume no kickbacks in my selected expense provisions:

Type	Data	Insurer Selected	CFA Selected	Fixed	Variable
Commissions	4.7%	15.0%	2.6[2]%	0.0%	2.6%
Other Acq	2.3%	2.4%	2.4%	1.2%	1.2%
General	9.4%	11.5%	5.0%	2.5%	2.5%
Taxes, fees	1.8%	2.3%	2.3%	0.0%	2.3%
Non-CAT profit		3.7%	3.7%	0.0%	3.7%
SUBTOTAL		34.9%	16.0%	3.7%	12.3%
Net Reinsurance Cost (Not analyzed by CFA)			22.3%		22.3[3]%

[2] These are extremely generous provisions. For instance, Commissions probably should be zero given the recent pronouncements by Fannie Mae and there is really no need for an agent to "produce" and service business, the tracking does that automatically. General Expense also, with tracking costs removed, should be less than 5 percent.

[3] The net reinsurance cost analysis is not public information and, consequently, could not be reviewed.

TOTAL	38.3%	26.0%	12.3%
PERMISSIBLE LOSS AND LAE	61.7%		87.7%

Premium Trend

CFA selected zero premium trend, so premiums are as reported, put on level but with no trend.

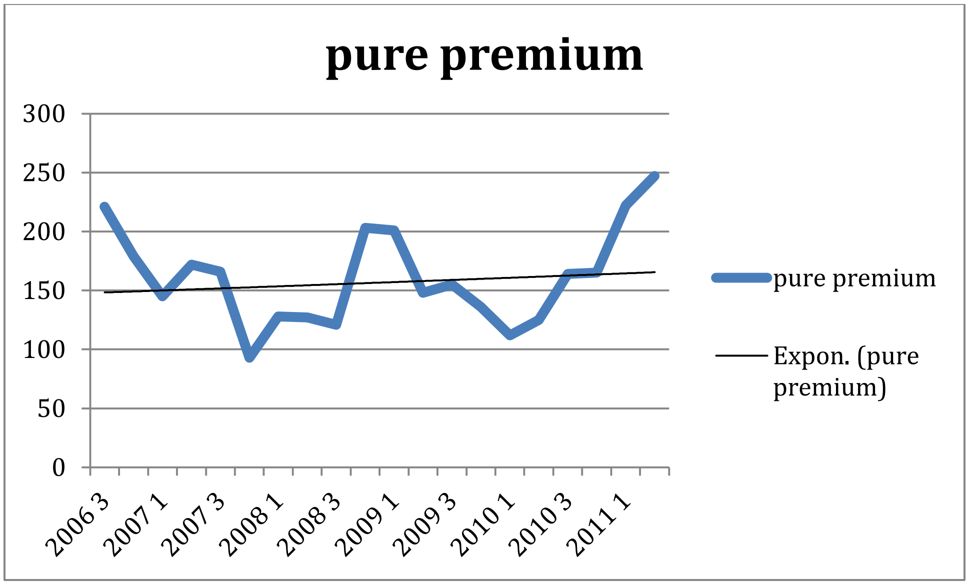
The reason Praetorian provided for a negative 3 percent premium trend is that rates may by regulated ("regulatory trends expected to reduce future premium"). The fact that premiums are going to face scrutiny is no reason to allow a negative premium trend. This allows an insurer to jack up a rate that they are about to be required to lower. Also, since there was no adjustment to loss trend for anticipated higher deductibles in the future, there should be no adjustment to premium trend for that possible effect.

Loss Trend

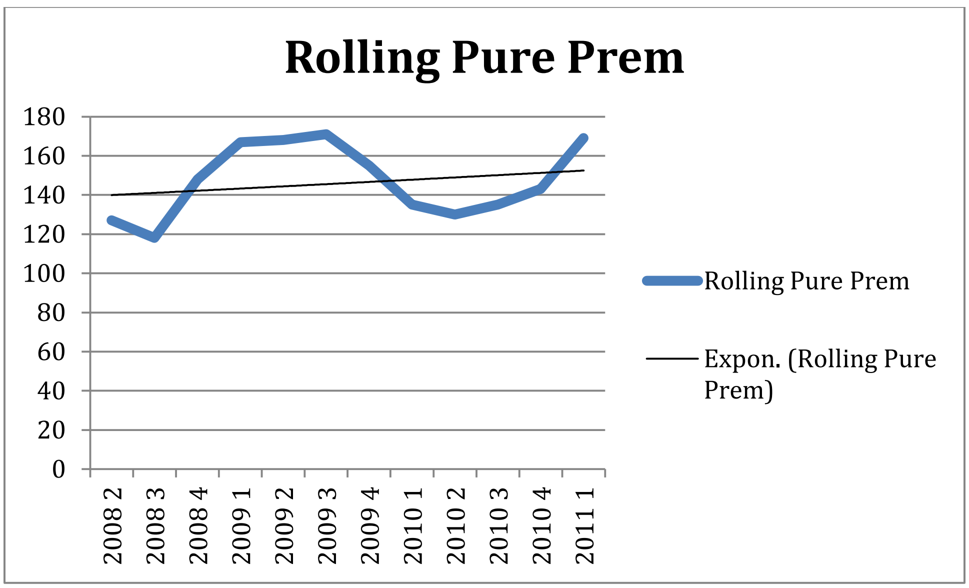
Praetorian, using very few data points, proposes an astonishing annual pure premium trend of 23.9 percent. I have never, in 40 years of reviewing filings, seen any trend factor like that.

The trend data[4] does show a recent spike in frequency, but that is likely related to recent CATs in early 2011. I looked at all the data and plotted the exponential trend lines. Here it is for the full five years of data reported by Praetorian. (This is not the rolling average but the actual pure premium numbers).

[4] The data are unclear as to whether paid or incurred losses are being used. If paid, the trend is skewed by the growth in exposures followed by flattening exposures and an analysis of that effect is required. If incurred, the impact of reserves must be analyzed. The trend data shows no analysis and we are not even sure what data are used. Separate review of Balboa and QBE experience is particularly important for trend analysis.



And here is the rolling average quarterly data for 12 points (the standard trend format that is used most in rate making):



Both of these lines indicate an annual trend under 5 percent. I have chosen a 5 percent exponential trend. The calculation of the non-CAT trended and developed incurred losses and LAE is:

6/30 Acc Year	Non-CAT Losses Incurred	Loss & LAE Development	Loss Trend	Non-CAT Trended & Dev Loss/LAE
2007	$3,788,681	1.000	1.390	$5,266,267
2008	$5,640,134	1.006	1.324	$7,512,342

2009	$9,701,715	1.028	1.261	$9,973,365
2010	$19,590,997	1.108	1.201	$19,590,998
2011	$23,653,996	1.424	1.144	$38,533,684

Rate Level Calculation

Based on the above changes, CFA calculates the proper rate level for FPI for Praetorian as:

Year	Earned Premiums On Level	Incurred Loss/LAE[5] plus non-Hurr	Loss/LAE Ratio w/ non Hurr CAT	Acc Year Weights
2007	$34,202,657	$5,549,472	16.2%	5%
2008	$81,383,328	$8,080,034	9.9%	10%
2009	$180,663,689	$11,093,064	6.1%	15%
2010	$425,682,727	$22,059,554	5,2%	25%
2011	$532,247,525	$41,514,962	7.8%	40%
			Weighted Loss Ratio	7.1%

Rate Level Calculation (Continued)

Projected Hurricane Loss Ratio[6]	15.9%
Projected Incurred L/R (Non CAT)	7.1%
Expected Fixed Expense Ratio	26.0%
Expected Variable Expense Ratio	12.3%
CFA Rate Level Indication	-44.1%
Company Indicated Rate Level	-15.6%
Company Selected Rate Level	0.0%

Conclusion

The request from Praetorian to leave rates unchanged must be rejected. Do not, however, fall into the trap of only reducing the rates by 15.5 percent, which Praetorian said is indicated. As I have demonstrated, Florida should require the insurer to reduce rates by at least 44.1 percent. The final indication, after full review of all components of the filing, will, we are sure, indicates a much larger decrease than 44.1 percent for reasons spelled out above. I urge you to carefully

[5] CFA did not review the LAE figures but we do note that the data on Page 8 of 25 of Exhibit 1 shows total non-hurricane LAE of $ million (Column 16 plus Column 20 for the five years with incurred losses of $52.1 million (Column 12) or a ratio of 19.8 percent, an extremely high provision that needs explaining.

[6] Not verified by CFA since these documents were not available for review (alleged "Trade Secrets").

review the “trade secret” material on hurricane CATs and hurricane reinsurance. If Praetorian used the same type of actuarial overreach in these hidden documents as they did in the public documents, a rate decrease of much more, up to 85 to 90 percent, would be justified.

Finally, I should point out that the filing is misleading and cherry picks among assumptions to try to jack up the indication and then, after all the manipulation fails to produce an indication of no change, the filer proposes that anyway. Making filings known to produce excessive prices for the borrower has gone on for decades in this business, as demonstrated all over the nation as observed loss ratios are far, far less that the expected loss ratios asked for in the filings.

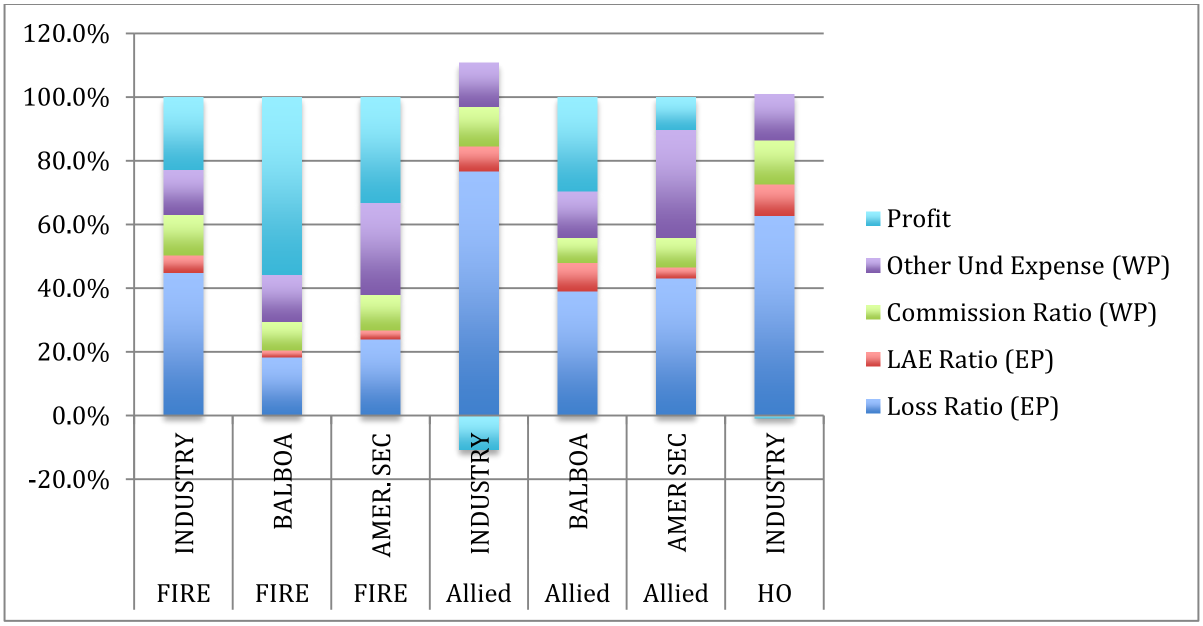
It is time to stop this sham. The Commissioner should send a message that protects Floridians and can be used as a beacon for all states as they strive to fix these outrageous practices. I also suggest to the OIR actuaries that they should consider whether the actuaries responsible for the current filing have violated actuarial standards and ethics and, if so, whether the violations rise to the level of submission to the Actuarial Board for Counseling and Discipline.

APPENDIX 2

	FIRE INDUSTRY	FIRE BALBOA	FIRE AMER. SEC	
Loss Ratio (EP)	44.9%	18.3%	24.0%	
LAE Ratio (EP)	5.5%	2.2%	2.8%	
Commission Ratio (WP)	12.7%	9.0%	11.1%	
Other Und Expense (WP)	14.0%	14.8%	29.0%	
Profit	22.9%	55.7%	33.1%	
Total	100.0%	100.0%	100.0%	
	ALLIED INDUSTRY	ALLIED BALBOA	ALLIED AMER SEC	HOMEOWNERS INDUSTRY
Loss Ratio (EP)	76.7%	39.1%	43.1%	62.7%
LAE Ratio (EP)	7.9%	8.9%	3.5%	10.0%
Commission Ratio (WP)	12.4%	7.8%	9.3%	13.8%
Other Und Expense (WP)	13.7%	14.7%	33.8%	14.3%
Profit	-10.7%	29.5%	10.3%	-0.8%
Total	100.0%	100.0%	100.0%	100.0%

Sources: 2001-2010 Industry National Data from Best's Aggregates and Averages, 2011 Edition.
American Security and Balboa: 2002 to 2011 national data from Statutory Page 14 of the Annual Statements of the insurer for loss ratios, Commissions and taxes. Other expenses from Best's Aggregates and Averages, taken from multiple editions.

Many years ago both insurers filed for expected loss ratios around the nation in the 55 percent to 60 percent range. As these data show, the filing projections were not realistic and, overall, the projections were more than double the reality.



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