American Security Insurance Company Response

To May 13, 2013 Testimony by Center for Economic Justice

As a leading provider of lender-placed insurance in Florida for nearly 25 years, American Security Insurance (ASIC) welcomes the opportunity to provide the Florida Department of Insurance Regulation with additional information related to our new product filing. Lender-placed insurance (LPI) is a safety net to protect homeowners, lenders and investors against property loss. The new lender-placed product ASIC seeks to offer in Florida addresses issues that emerged in the wake of the housing crisis and adapts well to the specific experiences and significant coastal characteristics of Florida.

Review of the testimony from Mr. Birny Birnbaum on behalf of the Center for Economic Justice surfaces ten broad themes related to lender-placed insurance. This response from ASIC addresses each of the topics, which surfaced in slides presented during the May 13, 2013 public hearing:

- LPI pricing (slides 9, 17, 31, 21-22)
- LPI loss ratios (slides 7, 8, 10, 11)
- ASIC volume in Florida (Slides 4-6, 12-13)
- LPI reasonable expenses (Slides 16, 18 – 20, 28, 29, 30)
- The FL OIR/Assurant “misrepresentation” (Slides 2, 3, 14, 22, 38)
- Profit Provisions (Slides 24-27)
- Captive Reinsurance (Slides 22, 32-34)
- Loss Trends (Slides 22, 35, 36)
- Scheduled Rating (Slide 37)
- CEJ Dissatisfaction with Trade Secret Exhibits (Slides 22, 23)

ASIC’s response will refer to lender placed insurance (LPI) and standard residential placed insurance (RPI). It also will reference expert testimony provided to the National Association of Insurance Commissioners(NAIC) at their meeting in August 2012 by John Rollins, FCAS MAAA (Rollins) of Rollins Analytics, Sheri Scott, FCAS MAAA (Scott) of Milliman, and Robert Hartwig, Ph.D. CPCU, President and Economist for the Insurance Information Institute. All are recognized for their expertise and actuarial insights about lender-placed pricing, catastrophe exposure, and the differences between LPI and RPI.

Topic: LPI Pricing

Assertion: Mr. Birnbaum asserts that the“non-underwritten nature of LPI as well as the significant catastrophe exposure are irrelevant to the calculation of adequate rates.”

Response: Lender-placed insurance protects, without interruption, the investment of homeowners, lenders and investors from losses without regard to the condition of the property, its loss history or occupancy. Particularly in hurricane-prone areas, lender-placed insurance may be the coverage of last resort. Exposures have increased significantly in hurricane-prone states and particularly in Florida. Greater catastrophe exposure and concentration impacts rate calculations.

Assertion: "LPI rates are excessive because they include kickbacks to the servicer in the form of commission to servicer-affiliated producers, subsidized or free non-LPI insurance services and quota share captive reinsurance."

Response: Agents who are affiliated with mortgage lenders and servicers who are appointed agents of American Security may be paid a commission since they are licensed insurance producers. As an agent of the company, the lender-affiliated agency is the interface and liaison between the carrier (ASIC), and the mortgage lender or servicer, as the policyholder. Similar to any other agent, the affiliated agency works with the policyholder to resolve issues and to assure that American Security adheres to and meets its obligations under the terms of the insurance policy between American Security and the lender or mortgage servicer policyholder.

Among the services that agents provide are:

- Billing and collecting premium
- Explanation of coverage specifics
- Coordination of support and resolution of inquiries from borrowers about lender-placed coverage and claims
- Assistance with the boarding of new loan portfolios acquired by a mortgage lender or servicer.
- Resolution support when coverage of properties is cancelled
- Review of claims handling and interface between the policyholder, borrower and American Security in claims related inquiries
- Participation in negotiations between the carrier and the policyholder with respect to program continuation or modification
- Monitor, interpret and manage hazard insurance compliance issues and requirements for the servicer at the state, federal regulatory (OCC,CFPB) and administrative (NFIP/FEMA), and investor level
- Prepare, review and manage disclosures, notifications and processes specific to hazard insurance
- Vendor review and management of insurance providers

Additional services performed by the producers in the LPI industry, affirmed to the NAIC by Scott, include "…creates and maintains specialized computer systems to extract the required information from the lenders/servicers' systems, to assist the insurance company with policy issuance and administration." Her testimony further provides ten years of industry results with regard to commissions paid. She concludes: "LPI commissions have consistently been lower than RPI and fire and allied commissions, and remain lower today. For example, in 2011, the national LPI commission rate was 9 percent, compared to an RPI national commission rate of 13 percent, and a national fire and allied rate of 12 percent." It is difficult to reach a conclusion that commissions are unjustified and unreasonable using these facts.

From a ratemaking perspective, all applicable expenses should be included in the building of the rate. Rollins states: "Ratemaking actuaries should incorporate the results and properly measure the insurance-related expenses in the development of rates." Commission expenses are normal and customary to include in the ratemaking process, and they are included in this filing on that basis. It is important to note, however, the new LPI product that is being presented for approval, provides ASIC with rate credits that automatically adjust premiums downward in the event commissions are reduced or no longer part of the agreements with affiliated agents or permitted by state regulations.

Assertion: Mr. Birnbaum suggests "quota share captive reinsurance is a reason LPI rates are excessive."

Response: Captive Reinsurance agreements are quota share or risk-transfer arrangements with legal and licensed captives. ASIC has no provision in its rates for the presence or absence of quota share insurance, except the following adjustment to the Expense Modification Plan allowing a reduction in rates to borrowers under certain circumstances.

The expense structure differs slightly when a quota share captive is present, due to the presence of ceding commissions, and this is reflected in the ASIC Expense Modification Plan. This plan allows for one- to-one credits to be applied to the rate when commissions are reduced below 12.5 percent, up to a total of 12.5 percent reduction. A provision has been added to the plan to allow clients with a quota share captive to participate, altering their expense structure to achieve rate reductions that are passed on to the borrowers.

Differences between LPI and RPI exist on a fundamental level, many based on the non-underwriting nature of LPI. Robert Hartwig, Ph.D. CPCU, President and Economist of the Insurance Information Institute, provided the following testimony to the NAIC:

"These factors…exert upward pressure on pricing and include the following:

- Concentration of catastrophic risk
- Lack of individual risk underwriting

- Automatic, continuous and retroactive coverage
- Financial responsibility”

Mr. Hartwig also notes that State residual market mechanisms do not automatically offer coverage to all risks, and can contain certain conditions under which risks are excluded. In these cases the LPI insurer functions as the true insurer of last resort, providing capacity where none other exists.

This is particularly true in Florida, where all residual market carriers require certain levels of underwriting.

LPI Loss Ratios

Assertion: Mr. Birnbaum asserts that LPI Loss Ratios are too low. He provides some comparison slides of Assurant LPI Loss Ratios to some other loss ratios, but does not identify the source of his data.

Response: ASIC does not know if his data represents loss ratios from some of the industry, all of the industry, or even if the carriers are writing similar coverage. Further, it is unclear whether these are developed, undeveloped, accident year, or calendar year loss ratios, or some mix of all of the above. Even more important, this exercise does not reflect the different conditions under which the various carriers write, the catastrophe exposure, and the continued ability to pay claims. Using the Birnbaum criteria, should a catastrophe put a number of underpriced, thinly capitalized companies into insolvency while leaving a company with prudent pricing and capitalization in business, the company remaining to pay claims would be accused of gouging its customers due to lower loss ratios than its now insolvent competition.

During the past few years, loss experience in Florida for ASIC has been favorable because there have been no major hurricane or wind events in the state since 2006. Yet, the exposure risk within the ASIC portfolio in Florida has more than doubled during this period.

The exposure and products underwritten by ASIC are very catastrophe prone. Our actuarial rate making assumptions are sound and reflect the significant catastrophe exposure in the state.

The methodology used by CEJ is flawed and not properly reflective of standard actuarial techniques used in ratemaking. Michael J. Miller, FCAS, has testified that assertions of excessive rates based on a limited retrospective examination of only non-catastrophe loss ratios on a national basis are “inconsistent with generally accepted actuarial practices and inconsistent with the way rates are calculated and regulated in the U.S.” In short, the foundational analysis necessary to fully evaluate rate adequacy on a prospective basis has not been performed by Mr. Birnbaum. The conclusions presented as fact are reached by a cursory examination of a limited amount of evidence without regard for standard actuarial techniques for ratemaking.

Principle 1 of the Statement of Ratemaking Principles defines an insurance rate as an "estimate of the expected value of future costs," establishing that all insurance ratemaking is prospective in nature. The actual costs associated with a particular insurance policy cannot be known at the time the insurance coverage is initiated and the rates are determined. This necessitates a projection of the future costs which are likely to be incurred while the insurance policy is in effect. In order for the price of the insurance product to be reasonably related to the costs associated with the future insurance coverage, it is necessary to base the rates on the projected costs, not the retrospective costs associated with past insurance coverage.

Insurance provided in the private market could not function if ratemaking were retrospective in nature. Insurance rates are never tested for adequacy or excessiveness by simply looking retrospectively at actual historical claims experience and financial results. Insurance rates are always calculated and tested for reasonableness based on the projected costs that were determined at the time the rates were implemented. The reasonableness of the projected costs is always judged on the data and information available when the rates were calculated.

ASIC Volume in Florida

Assertion: Mr. Birnbaum points to ASIC's growth in Florida, and the extent to which the total of LPI insurance in the United States is written in Florida. Mr. Birnbaum also suggests ASIC writes a higher premium concentration than exposure concentration in the state of Florida.

Response: ASIC is proud of its service to the state of Florida, and to represent a large, stable source of capacity to those insureds that have no other alternatives, and are unable to purchase coverage from the voluntary market. The exposures have grown in Florida because the need has grown for the product, due in part to other RPI carriers and Citizens' attempt to reduce exposures in the state. The high level of catastrophe hazard in Florida requires rates commensurate with the risk, and all carriers with a significant Florida catastrophe exposure, including ASIC, would exhibit a similar profile.

ASIC currently provides coverage in Florida on more than 142,000 properties, with a total insured value in excess of $30 billion. ASIC's A.M. Best rating of "A" reflects its continued commitment to provide stability to the Florida insurance market.

LPI Reasonable Expenses

Assertion: Mr. Birnbaum asserts expenses in ASIC are not reasonable.

Response: Commission expenses are addressed in another section of this response, with the other expense components expanded beyond as follows:

General Expense and Other Acquisition Expense

In his testimony to the NAIC Rollins states:, "underwriting expenses are different for LPI [lender-placed insurance] due to the product itself – a bulk master policy – as well as the unique activities associated with administering the book of risk." The inclusion of prospective expense levels is one of the basic tenets of actuarial ratemaking, and the cost levels of the unique activities referred to by Rollins must be analyzed and included as part of the methodology. General and other acquisition expenses are necessary to run and administer this newly filed program.

Expenses were not considered or discussed by Mr. Birnbaum, but considered by ASIC in the development of the new LPI program, including:

- Product construction and development
- Significant IT costs related to more complex pricing, user and system interfaces, and other technological developments required to sufficiently operate the more flexible program
- A more complicated administration of the new program compared to prior, simpler programs
- Additional resources necessary to maintain such a program in today's and tomorrow's economy and regulatory environment
- The cost of administering all loans within a loan portfolio for insurance coverage, including the costs associated with the placement process and the costs related to determining the appropriateness of the insurance coverage
- All other normal related expenses, including but not limited to: costs of conducting insurance operations, policy issuance, premium and commission reconciliation, policyholder services, legal, product support, compliance, general overhead, and salaries and benefits.

Tracking Expense

The specific expense known as "tracking" comprises much of a lender-placed insurer's exposure and risk management expense, and is explained here in more detail.

A lender-placed insurer such as ASIC may track tens of millions of loans. On these, ASIC contractually is obligated to provide automatic and continuous coverage on any loan for which there is not a valid insurance policy, as required by the mortgage contract between the borrower and the lender.

ASIC follows a rigorous, multi-step process to ensure that homeowners are aware of the fact that their policy has lapsed, providing instructions and seeking to minimize risk of error.

Open Items Process

ASIC monitors policy status for possible lapses in coverage, such as when a homeowner's standard policy has been canceled or is about to expire. If ASIC then confirms that it has not received proof of continuing coverage, it undertakes an extensive "open items" process.

It is at this point that ASIC attempts to obtain renewal information or other evidence of valid insurance coverage. Starting about 15 days prior to the expected coverage lapse, ASIC initiates multiple calls and other communications with homeowners' insurers, their agents, and borrowers themselves to find proof of insurance coverage. Through this "open items" process, ASIC avoids unnecessarily placing homeowners into the next phase of the process, called the "letter cycle." ASIC does not take into account loan characteristics such as delinquency to identify potential lapses in coverage, and delinquency status does not affect the rates that ASIC charges on individual policies under its products currently used.

Letter Cycle Process

If – and only if – proof of insurance coverage has not been received after the "open items" process is completed, ASIC begins the "letter cycle" process, which typically includes the following actions on behalf of the servicer:

- Around the date of expiration of the existing standard policy: ASIC sends a letter to the homeowner, informing him or her that the servicer does not yet have proof of coverage, as required, and reminding the homeowner to provide the proof of coverage. This letter also explains several ways for the homeowner to provide such proof to ASIC.

- 30 days later, if no response to the above letter: ASIC sends a second letter informing the homeowner that the mortgage lender still has not received proof of coverage and that a policy will be purchased if ASIC does not receive a response within a stated period, typically 24 to 30 days. This letter states that LPI coverage *will be more expensive* than the homeowner's prior standard coverage and will not cover liability or contents, as a standard policy generally does, and it encloses a binder that sets forth the annual premium to be charged in the event that an LPI policy is issued. This letter again explains several ways for the homeowner to provide proof of coverage to ASIC.

- <u>30 days later, if no response to either of the above letters</u>: The servicer places the ASIC LPI policy and sends the homeowner a complete policy package.[1] This package includes a letter that again encourages the homeowner to obtain standard coverage and explains that if the homeowner does so, the LPI policy *will be canceled and the homeowner will be charged only for the period when no other coverage was in place*.

And the system works. Historically, of more than 32 million home loans nationwide for which ASIC tracks insurance coverage, it identifies about 13 percent annually as being at risk of a potential lapse in coverage, triggering the "open items" process. After the open items process, about 9 percent of loans enter the "letter cycle." For about 3 percent of loans tracked, borrowers receive the second letter enclosing the binder, and LPI is placed for about 2 percent of such loans. Thus, as a result of ASIC's processes, standard coverage is maintained on the vast majority of properties with policies at risk of lapse or cancellation, and LPI is placed only on a small fraction.

Through the combination of tracking, letters and phone calls, as described above, ASIC is able to ascertain valid coverage on approximately 98 percent of loans, thus issuing policies on approximately two percent. The two percent, however, represents hundreds of thousands of policies and hundreds of billions of dollars of exposure nationally. The most critical state in which to understand exposure is the one most exposed to catastrophe risk, and that state for ASIC is Florida.

With more than 142,000 policies issued in the state of Florida, quantification of risk characteristics such as construction, location, and insured amount is critical in order to determine:

- Aggregation risk
- Probable maximum losses
- Needed reinsurance purchases
- Capital that needs to be held to pay claims in event of a catastrophe
- Capital and reinsurance as required by regulators
- Capital and reinsurance necessary for ratings agencies to provide insurance company rating information to prospective insureds.

Without this information provided accurately and on a timely basis, the insurer would experience:

- Significant increases in direct and contributive losses

[1] Although premiums may not be charged until the end of the letter cycle, the policy is effective from the date of expiration of the prior policy, providing the homeowner with continuous coverage. So, if a homeowner suffers a covered loss during this period, ASIC pays the appropriate amount to satisfy the claim so that the home can be repaired or rebuilt or the loan can be repaid.

- Higher reinsurance costs and/or availability issues

- Possible ratings downgrades by ratings agencies

- Inability to pay claims on a timely basis after a catastrophe due to lack of knowledge of property addresses

- Uncertainty as to how much capital would need to be held to protect policyholders

- A high rate of false policy placement, which both increases expenses due to excessive policy cancellations, and causes borrower irritation.

It is the insurance provider that takes on the risk of loss in an LPI program for all known and unknown uninsured properties. Such administration by the carrier has greatly improved the exposure management function. Doing so also has had the effect of keeping premium rates lower over time, by effectively charging premium for all identified uninsured properties and only those that are identified as uninsured, limiting false placements. Other property insurers incur cost to properly identify, catalog and analyze their exposure to catastrophic risk. This function is even more critical for ASIC, given the non-underwritten nature of the LPI product and is recognized as appropriate.

Assertion: Mr. Birnbaum's objections appear to be "somebody else should do this" and "somebody else should pay".

Response: A rationale as to why "somebody else" should assume these normal and customary risk-related insurer expenses is not presented. ASIC believes these responsibilities should remain with the insurer.

<u>Mischaracterization of expense and inclusion of non-insurance expenses</u>

Assertion: Mr. Birnbaum alleges ASIC's selected expense provision bear no resemblance to historical expenses, that non-insurance expenses are included, and that large servicers are electing to accept less commission.

Response: ASIC does perform some non-insurance services for clients on a fee basis. A more thorough review of the ASIC filing would have revealed:

- Non-insurance expenses have been excluded from the filing

- Expense have been re-allocated between Other Acquisition cost and General Expense.

Importantly, should large servicers elect to accept less commission, the expense modification plan in this program will automatically adjust rates downward, directly benefiting the consumer. ASIC wishes to offer this mechanism to produce rate savings to many Florida consumers as an inherent part of this filing. It is perplexing why the CEJ opposes such rate savings.

The FL OIR/Assurant "Misrepresentation"

Assertion: Mr. Birnbaum has chosen to impugn the integrity of the Florida Office of Insurance Regulation as well as ASIC.

Response: ASIC does not agree with this characterization of the Florida Office of Insurance Regulation which holds transparency as a hallmark of its rate-setting process.

ASIC also is proud of our reputation for compliance, quality and service to property owners in Florida. Backed by the assets of Assurant, ASIC has steadfastly upheld our responsibilities in Florida. Our actions and our filings are based on sound actuarial standards and disciplined operations that comply with all of the guidelines and rules of the Florida Office of Insurance Regulation.

Profit Provisions

Assertion: Mr. Birnbaum mentions ASIC's filed profit provision of 3.7 percent and 4.1 percent in 2009 and 2013 respectively as well as forward-looking assumptions.

Response: The 3.7 and 4.1 percent are the correct profit provisions filed, and which conform to the statutory provision allowed in the state of Florida at the time of each filing. ASIC submits periodic statutory filings of results. As a publicly traded company, Assurant, Inc. also is required to file quarterly and annual reports with the SEC and provides public updates on the company's performance. These filings include a broad base of specialty insurance businesses in the U.S. and select global markets. References to paragraphs from SEC filings reflect Assurant's consolidated business results and are not specific to LPI. In all disclosures, Assurant and ASIC recognize increased catastrophe exposure and the volatility of results inherent to that risk exposure.

For example, references to projections from a March 2011 investor presentation reflect various assumptions, including catastrophe experience nationwide (not just Florida) and across all of Assurant Specialty Property's product lines, not just LPI. Since then, actual returns differed and will continue to fluctuate due to the inherent volatility of catastrophes and lingering disruption in the U.S. housing market. All filings and investor presentations are publicly accessible at www.assurant.com.

Given the lack of numerical support, methodology or supporting evidence from CEJ, and ASIC's adherence to the profit provision required by the FL OIR, ASIC sees no basis in fact for the unsubstantiated assertions.

Captive Reinsurance

Captive Reinsurance agreements are quota share or risk-transfer arrangements with legal and licensed captives.

Assertion: Mr. Birnbaum suggests that captive reinsurance schemes are a profit-sharing mechanism for the mortgage servicer.

Response: The suggestion omits half of the truth. All the captive reinsurance agreements are quota share reinsurance with legal and licensed captives. Captive reinsurance arrangements are a profit **or loss**-sharing mechanism for the reinsurer. To the extent that the primary insurer receives a profit or suffers a loss, so does the captive. These transactions, as previously noted, do not create extra expense for the borrower and are irrelevant to the pricing of the product.

Loss Trends

Assertion: Mr. Birnbaum creates an exhibit with loss ratios, whether developed, undeveloped, by which product, it doesn't say. A second exhibit reflects a completely different set of loss ratios, none matching the first exhibit.

Response: It is unclear to ASIC what kind of loss or premium adjustments, if any, were made to either of the contradictory sets of data. It is unclear what ideas are incorporated and the actuarial process used to develop the trend factors. Many random numbers are drawn together without providing a coherent analysis to support the assertions. Further, the comments provided do not appear to reflect a review of ASIC's filing in Florida.

Schedule Rating

Assertion: Mr. Birnbaum describes schedule rating as unreasonable and discriminatory, based on his opinion that "LPI insurers have a history of padding LPI rates to create unjustified revenue..."

Response: The ASIC schedule rating plan employs the following criteria:

- Quality of Loan Underwriting
- Quality of Loan Portfolio
- Transactional Efficiency
- Management Experience

Quality of Loan Underwriting, Quality of Loan Portfolio, and Management Experience are all factors that influence the types of loans and manner in which loans are made. Certain lenders employ strict underwriting practices, or follow investor guidelines that specify strict underwriting practices. These include factors concerning the financial strength of the borrower, the willingness and ability of the borrower to repay the loan, the ratio of the loan balance to the value of the home, and the quality controls around the home appraisal process. Other lenders may be willing to lend while employing different or weaker standards relating to these various home and borrower characteristics.

As has been seen during the mortgage crisis, adverse economic conditions affect borrowers in weaker portfolios differently. Due to less stringent underwriting standards, less ability to repay, and higher loan to value ratios, a greater incidence of default occurs. Also, in portfolios where higher loan to value ratios are prevalent, where significant instances of loan values exceeding the property value may occur, the incidence of "strategic" default also is increased. In those cases where foreclosure is imminent or thought to be inevitable, the homeowner often loses interest in maintaining the home and performing the customary activities needed to protect the home against damage from various insured perils. The homeowner also may be less inclined to mitigate further damage should an insured event occur or a structural weakness be present. The significant negative correlation between the insured's recent financial responsibility history, here as evidenced by the actual or eventual entry into foreclosure, and propensity to generate insurance claims has been documented in numerous sources, recently in the testimony of Rollins.

Transactional Efficiency affects the expense component of the insurance transaction rather than the loss component. Because of the large amount of information exchanged between American Security and its insureds, the efficiency of this transfer affects the overall profitability of the transaction. At these volumes of data transfer, the effort involved in scrubbing, replacing or otherwise coping with poor or erroneous data is considerable. Numerous hardware and software exist to process this data, all with varying degrees of inter-operational compatibility. Data quality and compatibility are two of the more noteworthy attributes of transactional efficiency. As the evaluation of this is by necessity more qualitative than quantitative, this aspect of the insured's operation was included under schedule rating rather than the expense modification plan.

All four criteria of the ASIC Schedule Rating plan bear a reasonable relationship to the expected loss or expense experience of the risk, and are included in the filed rating plan.

CEJ Dissatisfaction with Trade Secret Exhibits

Some states, including Florida, require information for filings that is either proprietary, confidential, legally protected, or for other reasons cannot be released publicly. These states provide a mechanism by which such documents can be designated "trade secret", and not publicly released. We strongly believe the documents identified by ASIC in the filing fit the designation of trade secret.

Mr. Birnbaum does not appear to object to such documents not being released to the public, but he does appear to object to such documents not being released to him. As these protections exist for all concerned parties, and help ensure an orderly insurance marketplace, we believe the confidential nature of trade secret documents need be maintained.

It also is noted that many of the answers to Mr. Birnbaum's queries about the filing, particularly those referring to loss trends and expenses, as above, are clearly delineated in the filing in the non-trade secret exhibits.

ASIC's trade-secret exhibits could be subject to misinterpretation and misuse if the party requesting special access to proprietary information is not willing to properly interpret and analyze the information.

ASIC remains committed to a fully transparent process, and stands ready to respond to future requests for comment from the Florida Office of Insurance Regulation.