PRESENTATION TO THE FLORIDA COMMISSION ON HURRICANE LOSS PROJECTION METHODOLOGY

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My name is Werner Kruck, Senior Vice President with Security First Insurance Company of Ormond Beach, Florida, and I appreciate the opportunity to address the committee on the subject of Wind Loss Mitigation, which is an extremely critical part of Florida's battle to make homeowners insurance affordable in the long term.

Security First was started by former state Senator Locke Burt and his partner Harry Bleiwise in 2005. Initially the company did several takeouts from Citizens, but since October 2006 has written only voluntary business. We are a Florida company owned and operated by Floridians, and we only write residential dwelling business, and only in Florida.

As for my background, I have been developing residential property insurance products for over thirty years, on a countrywide basis and internationally. I have been directly working in the Florida homeowners market since moving here in December 2003.

Before I talk about some of the problems and issues around Wind Loss Mitigation regulation and practice from an insurance company perspective, I think that is important to state that all serious participants in this market must support effective incentives, including insurance discounts, for wind loss mitigation on dwellings as a matter of sound public policy for Florida. I read an article over the past weekend that seemed to suggest that people who have spent money to harden their homes against hurricane might be in danger of losing discounts from insurance companies. Nothing could be farther from the truth. As an insurer, we prefer to insure hardened homes owned by conscientious people, and will always be willing to provide discounts that will attract them to our company in an amount consistent with the expected claims savings.

The issue here is not really Wind Loss Mitigation, but how the implementation of statutes requiring insurance companies to provide WLM discounts is negatively impacting our ability to provide WLM discounts to insureds which are correctly priced and accurately applied.

An insurance company requires the following essential requirements in evaluating whether to provide a potential discount.

1. <u>Is there evidence or logical reason to believe that the presence of certain characteristics for a risk will result in a reduction in the frequency or severity of losses from covered perils?</u> This can come from the company's data, other industry data, models, observation or just plain common sense.
2. <u>Could the use of the factors in the company's rating plan create a direct or potentially indirect unfair discrimination which would be illegal or unethical?</u>
3. <u>Does the company have the information in its policy files to apply the discount to current customers automatically on renewal?</u> When an insurance company files a change to its rating plan, it normally has to be applied to all customers, not just new ones, and it is not legal or desirable to fail to give a policyholder a discount that they deserve solely because the company has never asked about the condition.
4. <u>Can the information be obtained and maintained accurately so that the discount is applied properly to those that deserve it?</u> If the company cannot accurately determine when to apply the discount, the company will be unable to validate that it is deserved and how much it should be.
5. <u>Can the company expect that anticipated loss costs will be reduced by an amount consistent with the discount?</u> A company cannot stay in business writing the best risks at an inadequate premium.

6. Once the company implements the new discount, how quickly and accurately can it calibrate the accuracy of the new discount in its rating plan? A discount which is anticipated to impact a cause of loss with a high frequency will provide data quickly. A discount that requires infrequent events to baseline can take years to validate.

Then there are two significant practical considerations to implementing a new discount plan.

1. Will the insurance department approve the introduction of the discount to our rating plan and the amount of the proposed discount?
2. What is the cost and timing involved in changing systems and processes to be able to handle the information for the discount?

Product and pricing decisions must be evaluated along these lines on a rigorous basis because of the complexity of insurance pricing, systems and regulation. Unfortunately, the political pressure to provide WLM discounts in the hope that those discounts would result in the hardening of Florida's existing housing stock meant that most of those fundamental business practices had to be ignored.

WLM Credits were simply mandated and for several years insurance companies have had to scramble to

a. Educate all of their key employees as to how the credits worked, and how they are defined. This education is still in process since the WLM characteristics that were mandated turned out to be significantly more complicated than they initially appeared.
b. Update their rate plans, filings, and computer systems.
c. Figure out how to apply the discounts to current policyholders when the information required to calculate the discounts had never been collected.

This has been a costly and difficult process for all companies. Mistakes were made in implementing the current system of WLM discounts and those mistakes are going to be costly to correct.

Accepting OIR form 1802 when signed by any licensed contractor has created the following problems:

1. A licensed contractor does not necessarily understand the construction attributes involved, or how they are applied to the credits, which can be slightly different than the building codes.
2. Because of the large amount of premium savings that can result from the current WLM credits, there is a significant incentive for fraud of various types by all parties involved in the process, including the inspector, insured and agent.
3. Data on re-inspections and investigations by some insurance companies indicate that over 50% of the inspection forms have been completed incorrectly. This means that the data used to apply the credits is not correct. It also means that the companies will not be able to judge the accuracy of the discounts actually provided to customers.

As a result, the public policy objective of incenting people to harden their homes is not being achieved. Instead, many people are simply using the current system to reduce their current homeowners premium without upgrading or hardening their home against future hurricane damage. Under the current system

1. People are rewarded for getting the right inspector or agent rather than for mitigation of their homes.
2. Companies are not getting the premium that they are supposed to be collecting, and rate increases that result to base rates will create, in effect, a subsidy of the cost of fraud and inaccuracy spread over all policyholders, including the ones who have mitigated.

3. Inaccuracy of data means that reinsurers will not use company WLM data in their cat models, but will use the market averages, so there is no developing reinsurance credit to offset the cost of the premium credits that are currently mandated.
4. When we do have a hurricane event, the industry will not be able to properly validate the credits against losses because the underlying data will be wrong.

Compounding the premium drain is that when the WLM credits were mandated, the OIR required the industry to assume that its current rates were for those homes at the lowest level of mitigation. This meant that the current WLM discounts caused only discounts for homes that qualified and not increases for homes that did not qualify. If a company's the rate level was adequate before the WLM credits were applied, the rates instantly became insufficient. It has taken several years for the impact of this to be fully manifest, as current policyholders got inspections and filed for discounts. During that period, the WLM discount factors were arbitrarily doubled which further compounded the problem of inadequate rates for the market.

Earlier today, Ken Ritzenthaler made two statements that were absolutely correct in regard to the impact of the loss of premium by companies due to the Wind Loss credits. First, he stated that the problem was only a timing difference, and that as companies made their filings, the indicated changes would eventually show the need for increases and the companies would raise their rates. Second, he stated that companies cannot "recoup" past losses by charging higher premiums. This means that the premium lost due to the credits will never be recovered. Since it will be a minimum of two years to reach the bottom and another two years to get the rate back to where it should be, we are looking at four years minimum of premium shortfall. Because Florida companies are highly dependent on reinsurance, over half of our costs are essentially "fixed" costs rather than variable costs that go down as the premium goes down. Given the range of numbers we have heard today on the potential size of the impact of the discounts, this pretty much assures that Florida residential property programs will be unprofitable to some degree and for several years.

No one really knows for sure what the relativities and discounts should be for the WLM characteristics that are used for the credits. The current credits represent one modeling company's estimate based on their model. Unfortunately, this not the computer model that most companies use for pricing and obtaining reinsurance. Therefore, there is no connection between an insurance companies reinsurance costs and the discounts that the company must provide to policyholders. While there does not appear to be anything in the statutes that would prohibit the use of another approved model to establish WLM relativities the recent attempt by State Farm in a file and use submission to implement a new system of WLM credits based on the relativities contained in the RMS model was rejected by the OIR.

Another unintended byproduct of mandating a single approach for WLM credits is that it stifles creativity and slows the adoption of new mitigation techniques. Builders and others in the construction trades continue to create new products and processes intended to mitigate wind loss. In the current environment, it is not practical for an insurance company to offer discounts for any new construction materials or techniques. Prior to adopting any new discount the OIR will require proof of the accuracy of any new discount. In many jurisdictions, when an insurance company wants to find out if a new discount makes sense, it will normally implement a small discount to encourage agents and insureds to provide the new accurate information to qualify for the discount, even though the company cannot validate the discount at that time. Over time, as people take advantage of the new discount, the insurance company can validate the discount as losses are experienced and adjust. This approach has generally not been supported in Florida.

For example, after Wilma, the company that repaired the roof of my home in Coral Springs told me of a technique they had developed where they used long screws to anchor the ridgeline of concrete S-tile roofs by drilling holes on each side of the tiles and screwing them into the roof. I had it done to my home for about $900.I would not consider filing a discount for this in the present environment. Or, how about metal roofs? New coatings have made metal roofs attractive and Californians are turning to them because they can dramatically reduce air conditioning costs and resist ignition from wildfires. They are also structurally superior in many ways to shingle or S-tile roofs. While metal roofs might, objectively, be entitled to some type of discount it's unlikely that we could develop enough data to have that filing approved. Mitigation is the only long term solution to Florida's "hurricane problem", and we desperately need a collaborative process that involves all parties working together to provide verifiable incentives and encourage creativity in construction and retrofitting. We do not need regulation that dictates the form, function, and amount of mitigation. As Americans, we meet challenges through ingenuity, and we cannot afford to stifle it.

What are we doing at Security First?

We are working on a program of validating that we have accurate WLM data for each of our policyholders so that they have all of the credits that they are entitled to under the law, and none of the ones they are not entitled to. This involves a new approach to the form 1802 process for new business, and a re-inspection program for current policyholders. We will be working with a third party to establish a single platform for reporting inspection results and ensuring quality, and will create a network of preferred inspection firms who will use that platform exclusively. On new business, because we are required to accept a form 1802 signed by any licensed contractor, we will do so, but if the inspection has been done outside our network, we will re-inspect. At the same time we will begin re-inspections, starting with locations and credit combinations most likely to be inaccurate. In order that we can more accurately communicate and administer WLM issues, we are putting all of our Sales, Underwriting, Customer Service and senior management through the same training course used to train WLM inspectors by our third party partner. This will get us the accurate information we need to validate the discounts against our experience and benchmark for reinsurance assessment.

What can this commission do?

This hearing is a good start. Understanding the current system is the first step toward improving it. Additionally, I would urge that the Commission consider recommending the following changes to current law:

1. Remove the statute (627.711(2)) that requires the Form 1802 to be accepted by the company if signed by a licensed contractor. This just adds cost to the system as we will need to re-inspect anyway when an insured selects a source whose accuracy we cannot rely on.
2. Expressly allow a company to use the relativities of any approved model for WLM credits, and include any variables or risk characteristics that are in the model.
3. Make WLM fraud a felony if the amount of the fraud exceeds a certain threshold.
4. If WLM credits are mandated by statute or OIR rule, then those WLM credits should be reflected in the FHCF rates as well so that our underlying reinsurance costs track with the discounts we are forced to provide.
5. Form a task force to evaluate the My Safe Florida Home Program and develop a model program that establishes a solid base for inspections and an industry sourced revenue stream. Consider the following:
    a. All WLM inspections would be required to be done by a licensed MSFH inspector. The program would maintain training and performance standards.
    b. Inspections would be presented by the inspector directly to a database where the insurance company would access them.
    c. Revenue for the MSFH program would come from fees paid by inspectors for their MSFH accreditation and insurance companies when they access inspections.

6. Form a task force to review the implications of the new WLM study and recommend how it should be applied. Note that the manner in which the original was put in made sure that policyholders only realized discounts, and changes could and should create relative premium increases this time around.
7. Mandate that Citizens re-inspect a major portion of their policies for WLM accuracy and institute procedures to obtain accurate information on new policies. This will prevent policyholders who will see an increase due to a re-inspection by their insurance company from taking an incorrect form over to Citizens.

I would like to thank the commission for allowing me to share my thoughts, concerns, and observations concerning wind loss mitigation. I would again emphasize that as an insurance company, and more important, as Florida citizens ourselves, we vigorously support discounts for effective mitigation, and we have no intention of advocating their withdrawal. Working together with regulators and others in the industry, we can make changes that will result in effective mitigation which works for all of us. We are committed to participating in that process and stand ready to support those efforts.

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