Considerations When Developing Actuarially Sound Rates for Lender Placed Property Insurance

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Discussion Topics

1. Insurance ratemaking actuarial principles
2. Lender Placed Insurance (LPI) ratemaking
3. Minimum loss ratio considerations
4. Conclusion

Insurance Ratemaking Actuarial Principles

CAS Statement of Principles Regarding P&C Insurance Ratemaking defines a rate as:

The **expected value of all future costs** associated with an individual risk transfer.

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LPI Ratemaking

Insurance Rate = Expected future non-catastrophe loss & LAE

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Expected future catastrophe loss & LAE
(Including cost of reinsurance)

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Expected future expenses
(Portfolio exposure analysis, placement, / UW / policy issuance and cancellation, etc.)

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Target profit and contingency commensurate with risk

Ratemaking is a prospective exercise

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LPI Ratemaking – Non-Catastrophe Loss & LAE

- LPI is take all comers. No individual property underwriting.
- Underwriting of lender's portfolio at the portfolio level.
- Unique properties of non-catastrophe rating for LPI portfolios include higher percent of:
  - Vacant / unoccupied / unmaintained properties
  - Theft / vandalism losses, some intentionally caused by homeowner
  - Properties that do not meet underwriting guidelines of RPI carriers
  - Portfolio underwriting performed using information in tracking system

LPI has a different profile of risk than RPI

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LPI Ratemaking – Catastrophe Exposure Since 04/05

- Growth in residential dwelling construction in catastrophe areas
- Increase in replacement cost and loan balances
- Insurance availability issues in catastrophe exposed areas, creating growth of LPI in catastrophe relative to non-catastrophe
- Reduced reinsurance capacity and increased catastrophe reinsurance costs for LPI

Geographic concentration in cat areas & increase in cat exposure for LPI

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LPI Ratemaking – Expense Component LPI vs RPI

- RPI expense based on marketing, sales, underwriting future policies, policy issuance & other expenses for exposures accepted by insurance company.
- LPI cover's lender's collateral as soon RPI insurance inadequate, whether or not discovered as requiring LPI policy. Determining exposure and reinsurance management are insurance company's responsibility. For LPI this includes constant evaluation of lender portfolio (called tracking) & data quality.
- RPI incurs a cost to underwrite individual properties and decides to accept those most appropriate given the rate and market it serves. LPI knows very little about individual properties and does not have the opportunity to underwrite each house. LPI accepts all properties within the lender's portfolio. Underwriting the lender's portfolio and constant evaluation is a warranted cost to LPI insurers.

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LPI Ratemaking – Expense Ratio Comparisons

Total Expenses Incurred as % DWP - All States

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	10yr Avg
Lender Placed (Note 1)	31%	33%	33%	32%	32%	28%	24%	25%	22%	22%	28%
Homeowners (Note 2)	28%	27%	27%	25%	26%	26%	27%	26%	26%	26%	26%
Fire and Allied	24%	24%	26%	26%	24%	25%	26%	26%	27%	26%	25%

Notes:

1. Lender Placed Insurance (LPI) 2 major carriers are American Security Insurance Co., and Balboa Ins. Co. and it's affiliated P&C Insurers. Balboa is affiliated and includes Meritplan Ins. Co, Newport Ins. Co, and Newport E&S Ins. Co. LPI lines of business are fire & allied. Voluntary Homeowners inlcude 3 major carriers in NY State, which are State Farm Fire & Casualty Co.,
2. Allstate Insurance Co., and Automobile Ins Co. of Hartford, accounting for around 30% of market share in NY.

LPI is a commercial fire and allied product with 10 year average expense ratio within 2 points of Homeowners

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LPI Ratemaking – Target Profit & Contingency

LPI is a high risk product warranting a target profit commensurate with the risk. High risk elements include:

- Limited information on individual properties & no underwriting of individual properties
- Take all comers
- Geographic concentration and catastrophe accumulation

Higher risk warrants a higher target profit commensurate with risk.

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Minimum Loss Ratio Considerations

- 80% minimum loss ratio does not appear to have been set using actuarial ratemaking principles
- Based on an actuarial analysis of past 10 years LPI expense ratios, 80% minimum loss ratio results in negative return on equity
- Negative return on equity is not sustainable
- Contemplating an MLR on a product with significant volatility, without an actuarial analysis of expected future costs is illogical and inconsistent with basic ratemaking principles

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Conclusion

LPI ratemaking is a complex process involving future risk transfer costs for a commercial entity with real property as collateral. Requires understanding of:

- Lender's data, processes and commercial exposure
- Accepting all properties in a lender's portfolio and given only lender portfolio information
- Insurance and reinsurance availability issues
- Catastrophe exposure
- Lender and real estate market cycles

Appendix

Appendix

Lender Placed and Voluntary Homeowners Insurance

Homeowners Insurance Statistics for the Past Ten Years (Note 1)

Direct Earned Premium (thousands)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Lender Placed Insurance (Note 1)										
NY	$22,780	$27,666	$28,427	$29,622	$41,508	$60,935	$87,290	$122,602	$145,424	$157,812
FL	60,757	80,269	83,932	91,546	144,993	271,774	560,384	831,200	983,915	977,840
LA	6,983	9,890	10,945	12,827	15,018	17,230	22,723	29,492	39,740	43,582
National	459,827	633,801	686,713	748,315	954,282	1,489,363	2,462,324	2,873,978	3,189,073	3,085,337
Homeowners - Industry Aggregate										
NY	$2,563,116	$2,775,125	$3,044,453	$3,314,919	$3,539,395	$3,751,251	$4,025,404	$4,164,479	$4,288,969	$4,432,034
FL	3,399,201	3,998,007	4,627,164	5,526,032	6,779,039	8,612,764	7,749,506	7,023,611	7,285,444	7,635,575
LA	717,268	822,591	902,654	1,042,274	1,148,686	1,295,638	1,378,836	1,465,255	1,531,838	1,569,842
National	40,173,086	46,168,239	51,712,303	56,397,133	60,006,490	64,385,905	65,291,211	66,711,351	69,930,084	72,905,255

Notes:

1. Lender Placed Insurance (LPI) 2 major carriers are American Security Insurance Co., and Balboa Insurance Co. and its affiliated P&C Insurers. Balboa is affiliated and includes Meritplan Ins. Co, Newport Ins. Co, and Newport E&S Ins. Co. LPI lines of business are fire & allied.
2. Direct Earned Premium are from Statutory Page 14.

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Commission as % DWP

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Lender Placed Insurance (Note 1)										
NY	7%	10%	10%	10%	12%	16%	12%	11%	6%	8%
FL	10%	11%	11%	10%	12%	12%	9%	9%	5%	8%
LA	11%	11%	10%	11%	14%	15%	10%	10%	7%	8%
All States	11%	13%	13%	9%	11%	13%	9%	9%	6%	9%
Homeowners - Industry Aggregate										
NY	15%	15%	16%	15%	15%	15%	15%	15%	15%	15%
FL	13%	12%	13%	14%	12%	12%	12%	13%	13%	12%
LA	12%	12%	13%	13%	12%	12%	12%	13%	13%	13%
All States	14%	14%	14%	14%	14%	14%	13%	13%	13%	13%
Fire and Allied Lines - Industry Aggregate										
NY	12%	13%	13%	13%	11%	12%	12%	12%	12%	12%
FL	12%	13%	13%	13%	11%	11%	11%	12%	11%	11%
LA	13%	13%	15%	13%	14%	12%	13%	12%	12%	12%
All States	13%	13%	14%	13%	11%	12%	12%	12%	12%	12%

Notes:

1. Lender Placed Insurance (LPI) 2 major carriers are American Security Ins. Co., and Balboa Ins. Co. and its affiliated P&C Insurers. Balboa is affiliated and includes Meritplan Ins. Co, Newport Ins. Co, and Newport E&S Ins. Co. LPI lines of business are fire & allied.
2. Direct Written Premium and Commissions are from Statutory Page 14.

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