Considerations in Actuarially Sound Rates for Lender-Placed Property Insurance

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The Bottom Line

• Lender-placed property insurance (LPI) is subject to most of the same actuarial considerations and cost provisions as standard residential property insurance (RPI)
  – Rates are regulated by states; some filings (Florida) are public
• Some LPI actuarial issues need special attention and potentially higher cost provisions
  – Catastrophe expected costs
  – Contingency factors
  – Underwriting expenses
• Actuarial review of public data provides insights
  – Catastrophe costs may be plurality of entire sound rate
  – Some rate filings have extensively supported cost structure
• LPI rates should be, and have been, justified independently to regulators
  – Simple comparisons to RPI cost structure are misleading and irresponsible
Basic Actuarial Fair Premium Formula is Similar for LPI vs. RPI

\[ P = \frac{L_N + L_C + R + F}{1 - \nu - \pi - \varepsilon} \]

• Fair premium (P) comprises several components:
  • \( L_N \) = Non-catastrophe losses per policy
  • \( L_C \) = Catastrophe losses per policy
  • \( R \) = Cost of capital backing risk (reinsurance plus retained earnings), allocated per policy
  • \( F \) = Fixed underwriting expenses per policy
  • \( \nu \) = Variable underwriting expenses (those charged as % of premium)
  • \( \pi \) = Profit loading (allowed as % of premium)
  • \( \varepsilon \) = Contingencies loading (allowed as % of premium)

• All components are expected prospective costs; no recoupment of past costs

• Catastrophe costs estimated from scientific simulation models; past data too volatile and unrepresentative of future exposure to be used as basis

• Cost of capital also tracks catastrophe exposure that can be >10x annual premium
In Risky Regions like Florida, Rates May Depend More on Catastrophic Costs than Routine Loss Ratios

Total RPI catastrophe costs are over 40% of the premium dollar, non-cat loss only 33%
LPI insurers show similar ratios in Florida rate filings

Source: Florida Office of Insurance Regulation, rate indications in 77 RPI rate filings since Jan. 2011, ratios scaled to add to 100%

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Catastrophe Costs are Driven by Geographic Concentration, Putting LPI at Higher Risk

• Cost of capital based on relationship of Probable Maximum Loss (PML) in worst-case scenarios to average annual loss (AAL) over time

• LPI accumulates greater relative catastrophe risk than RPI
  – Entails bulk acceptance and automatic coverage, no “risk picking” to spread exposure around a region
  – Takes risks even “wind pools” don’t cover
  – Placement driven by local economic troubles, which are inherently concentrated and often overlap catastrophe-exposed areas
Catastrophe Risk is Significant Along Entire East Coast

Hurricane loss potential noticeable in many high-density areas and even inland areas

Underwriting Contingencies are Greater for LPI

• Automatic acceptance and coverage increases the chance that actuaries “miss” expected loss estimates
  – Hazardous aspects of property are undetected
  – Coverage granted even if losses have already occurred
  – LPI placement signals financial responsibility concerns

• When property data precludes proper risk classification, contingencies factor should be higher to compensate for greater measurement error
LPI Rates Have Been Actuarially Developed and Rigorously Reviewed by Regulators

- Assurant (American Security Ins. Co.) made rate filings in Florida in 2006 and 2009 which addressed every actuarial rate component
  - Catastrophes, profit, contingencies, underwriting expenses
- Regulators approved rates after several rounds of questions regarding expense levels
- The outcome is consistent with good public policy that LPI rates should be developed and supported independently
- By contrast, comments characterizing LPI rates as “excessive”, “unreasonable”, or “a deception” are not supported by recent actuarial or regulatory reviews
  - Retrospective data, inappropriately applied, is no substitute
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