Market Review
May 22, 2017

Florida Market Faces a New Kind Of Storm

AOB increases severity of losses and litigation costs

Fortunately for insurers, Mother Nature has been relatively quiet in Florida for the past decade. Hurricanes, by and large, are the biggest and most unpredictable threat most property insurers face in the state; these storms represent a principal and well-researched risk for which many insurers have developed extensive mitigation strategies. However, damage from recent hurricanes has been somewhat subdued owing to more favorable storm paths. Nevertheless, despite the lack of severe hurricanes, the Florida market has not been without its challenges. A number of threats have emerged over the past decade, from the impact of sinkhole losses several years ago, to the recent sudden rise of assignment of benefits (AOB) issues.

Negative Impact of Assignment of Benefits

Adding to the pressures brought on by hurricane exposure and an untested dynamic given a number of new companies in the Florida market, is the negative impact of the AOB, particularly regarding homeowner water claims. On its own, the AOB process allows an insured to assign payment of a claim to a third party. This allows for the third party—in Florida's case, contractors—to be paid directly by the insurance company, rather than the insured paying and subsequently being reimbursed. Contractors in turn are afforded the rights of the insured and essentially "stand in their shoes." As such, contractors are protected by the same legislation meant to protect the insured—most importantly, the one-way attorney's fee rule. This rule dictates that, if an insured is able to prove that he/she is entitled to a larger indemnity payment of any amount, he/she is also entitled to the repayment of the associated attorney's fees incurred in the pursuit of restitution. Furthermore, the rule is structured in a way that the insurance company cannot recover its fees even if it wins the case.

Some Florida contractors are using this rule to their advantage, actively soliciting property claims and encouraging the use of AOB. The practice is most prominent in South Florida, specifically the Tri-County region. In some cases, unscrupulous contractors are driven by the intent to acquire the rights of the insured, so that they have more control over services rendered—which they then inflate, undertaking unnecessary repair and remodels for which they subsequently request reimbursement from insurance companies. In that event, these contractors are provided all the rights afforded by the AOB clause and the one-way attorney's fee rule. According to the Florida Office of Insurance Regulation's (FLOIR) 2016 Data Call Study, litigated claims are now more than double the cost of non-litigated, and non-litigated claims under an AOB are double the cost of those without.

In these cases, claims are regularly reported to the insurance companies after repair work has been completed. These claims are filed without proper inspection, leaving insurers unable to accurately assess the covered damage. Companies face a tough decision: Pay inflated costs or bring the issue to court, where they may prove costs are unjustified but will still incur legal fees. The decision to bring an issue to court is made more precarious because the threat is amplified by the one-way attorney's fee rule. If the court finds the insurance company liable for any amount more than what it has determined, the insurer must pay both the contractor's attorney's fee and the repair cost, in addition to its own attorney's fee. The issues have increased losses and loss adjustment expenses for companies in Florida. Given the significant impact on results, many insurance providers

Analytical Contact:
Chris Draghi, Oldwick
+1 (908) 439-2200 Ext. 5043
Chris.Draghi@ambest.com

Contributor:
Bobby Skrabal

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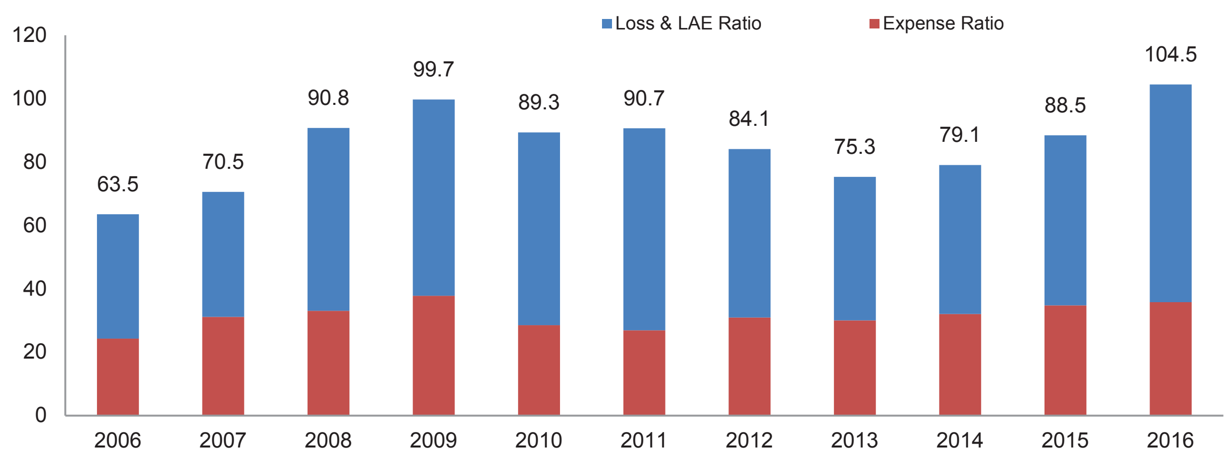
are challenging the AOB claims while seeking ways both internally and in the Florida legislature to combat the issue.

Because of the AOB claims, insurers are suffering from unexpected and significant increases in indemnity payments and litigation fees. AOB issues not only are driving increases in both litigated and non-litigated claims, but they are also leading to proportionately larger increases on non-litigated claims even though dollar costs are higher for litigated claims.[1] According to the FLOIR, AOB lawsuits in Florida rose from 405 in 2006 to 28,200 in 2016. The number of water claims and the severity of such claims are also rising, causing deterioration in results, particularly in recent years, as **Exhibit 1** shows. Per FLOIR's 2016 Data Call Study, since 2010 AOB claims have driven increases in water claims frequency by 46% and in severity by 28%, which in combination translates into a 14.2% increase in water claims losses per year. In South Florida, the average AOB claim costs $32,000, nearly three times the average non-AOB claim.[2] In an effort to address the issue, many companies have responded by adding bench strength to their claims and litigation teams, which helps lower loss and external attorney payments but also increases staffing costs. Either way, there is an added cost associated with the new AOB dynamic, and the reality is insureds will bear some of the cost through higher rates. According to the FLOIR, 73% of rate filings in 2016 were for rate increases, and homeowners can expect to see 10% rate increases in the future.

Exhibit 1
Florida Fire Lines & Home Multi-Peril Segment* – Combined Ratio
(%)



* Florida Fire Lines & Home Multi-Peril Segment is composed of companies whose Florida Fire Lines & Home Multi-Peril direct premiums written constitute 75% or more of their overall direct premiums written.
Source: A.M. Best data and research

The Florida companies A.M. Best rates have implemented several strategies to help minimize the impact of AOB issues. Diversifying into commercial lines, avoiding certain risk-prone areas, and carefully monitoring exposures have helped to partially mitigate the impact of AOB losses. Citizens Property Casualty Insurance Corporation has developed policy language limiting the amount of emergency repair work that can be done without an inspection—language that several providers have adopted to protect themselves. In addition, insurance companies have implemented preferred contractor programs and increased post-event response times and inspections, with varying degrees of success. Companies have also strengthened reserves to account for rising costs and injected additional capital to protect their positions.

[1] See Non-Catastrophic Homeowners Water Claims – Citizens Report.
[2] See Florida's AOB Abuse by the Numbers.

Recent Court Decisions Adding Concern

Two recent court decisions have given rise to some added concern regarding the state of the market in Florida. The first, Johnson v. Omega, essentially reinforced the concept that if an insurance company is found liable for any amount more than initially offered, the insured is entitled to reimburseme entire nt of his/her attorney's fee. The second, Sebo v. American Home Assurance Company, ruled that when no single cause of damage can be determined, the concurrent causation rule would apply, whereby the insured is entitled to coverage when there are multiple causes contributing to a loss, one of which is covered. This differs from the proximate causation rule, which allows for a denial of coverage if the predominant cause of loss is an excluded item.

These court cases upheld concepts known to A.M. Best-rated entities and for which they either already have or are developing mitigation strategies. The one-way attorney's fee rule remains a challenge, while the concurrent causation concept is mitigated with more deliberate policy language. For all Florida companies, the rulings in these court cases strengthen the ability of contractors and insureds to recoup payment for damages caused and found to be covered, but the concurrent causation ruling expands the potential for an insurer to be liable.

Market Participants Shift

Before the rise of AOB claims, Florida's insurance market had experienced a tumultuous period of severe weather in the early 2000s, leading to apprehensive insurers becoming wary of taking on hurricane-prone business. As a result, the Florida Legislature and the FLOIR collaborated and created Citizens Property Casualty Insurance Corporation, in 2002. This entity was created to offer a suitable and affordable replacement insurance option, as insurance carriers began to lessen their risk appetites for the Florida property market following a string of severe hurricanes in 2004 and 2005. At its height in 2012, Citizens had 1.5 million in-force policies, accounting for more than 20% of Florida's entire residential property market.

The growing risk exposure substantially increased financial pressure, prompting the need for Citizens to move risk off its books. As a result, the company focused on incentivizing insurers to participate in depopulation programs designed to return Citizens' policyholders to the private market. Depopulation benefitted from an advantageous market that was emboldened with favorable reinsurance conditions following the period of benign weather after 2005. More affordable reinsurance motivated carriers to participate, because companies could protect themselves from the assumed Citizens' risks at a lower cost. Assumptions were not without risk, given that the success of these companies hinged on effective exposure management and strict underwriting guidelines. However, the program proved successful, lowering Citizens' in-force policy count to 490,000 by the end of 2016.

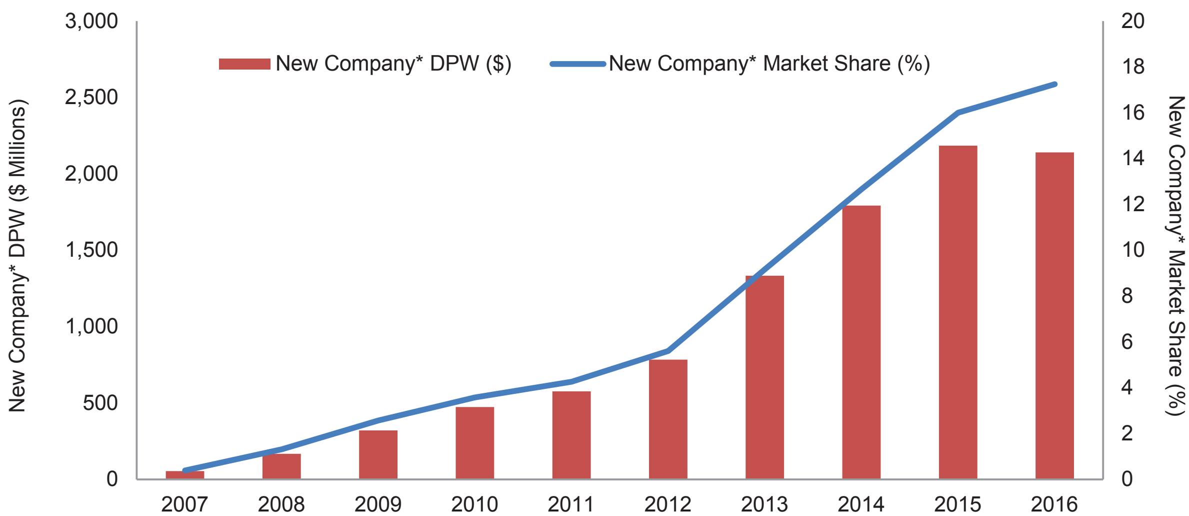
Exhibit 2
Top 15 Insurers by Citizens' Policies Assumed

Rank	Company Name	Total Policies Assumed
1	Heritage Property & Casualty Insurance Company	339,525
2	Homeowners Choice Property & Casualty	267,696
3	Southern Oak Insurance Company	213,024
4	American Integrity Insurance Company of Florida	202,062
5	Florida Peninsula Group*	192,232
6	Safepoint Insurance Company	123,979
7	Southern Fidelity Property & Casualty Inc.	117,175
8	Magnolia Insurance Company	116,040
9	United Property & Casualty Insurance Company Inc.	101,884
10	Mount Beacon Insurance Company	76,686
11	Tower Hill Group*	69,217
12	Anchor Property & Casualty Insurance Company	50,760
13	HomeWise Preferred Insurance Company	49,981
14	Elements Property Insurance Company	49,141
15	Weston Insurance Company	48,311

*Includes multiple individual take-out companies.
Source: https://www.citizensfla.com

The volatility in the Florida market led not only to the rise and subsequent decline of Citizens, but also to a shift from large national writers and their subsidiaries to newly formed property writers. Though national writers retained a significant portion of market share, their aggregate percentage dropped as that of the smaller domestic carriers grew. As Exhibit 3 shows, the percentage of property business written by companies formed after 2006 has increased substantially and now constitutes nearly 20% of the market. This shift was partially prompted by the Citizens depopulation program: Insurers saw an opportunity in Citizens assumptions and created companies to participate. These companies became known as "take-out" companies.

Exhibit 3
Florida Fire Lines & Home Multi-Peril Market Share for Companies Incorporated After 2006



*A new company is one incorporated in or after 2007.
Source: A.M. Best data and research

Take-out companies have been relatively untested by a truly severe hurricane, but they are being tested by the storm created in the AOB environment. When these companies were formed, the AOB issue was not as widespread as it is today. In some cases, the AOB issue has had a more severe impact on take-out companies because not all were prepared to shoulder the added AOB cost for a prolonged period. Rising losses and litigation costs have had a profound effect on Florida companies who are dependent on the Citizens assumptions.

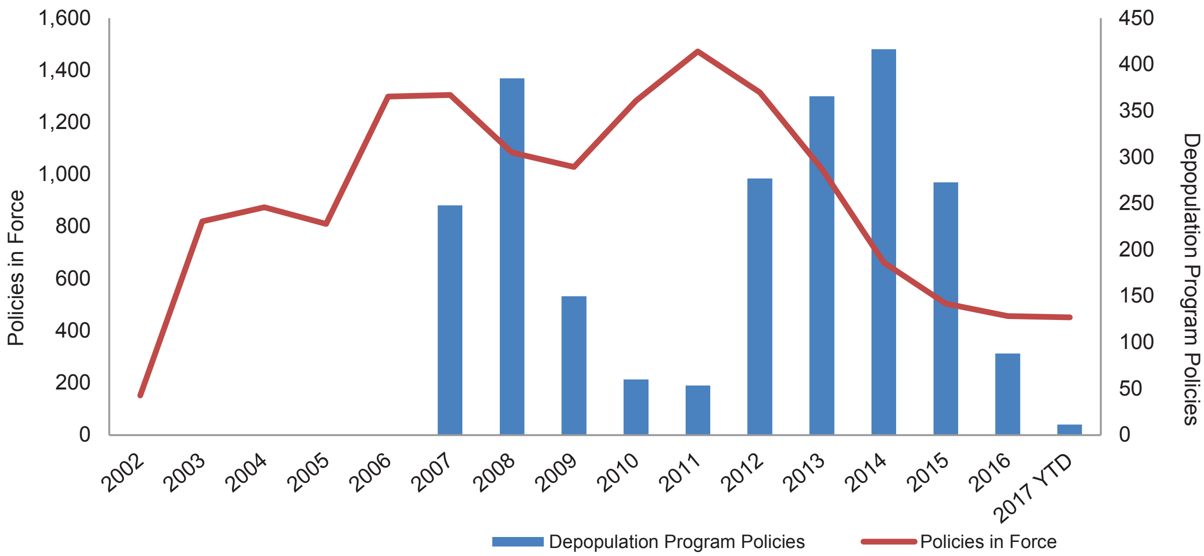
Market Implications: Pricing and Availability Affected

Pressures brought on by rising costs have led the insurance market to turn to the Florida legislature for help. Unfortunately, calls for a bill that would curb AOB abuse have failed the past five years. Just this April, the most recent bill failed to pass; it had proposed awarding fees using a formulaic approach based on judgment and included insurance company protections for AOBs regarding litigation and assignment agreements. Supporters say they will keep moving forward and have turned their attention to 2018.

The AOB crisis has and will likely continue to significantly affect insurance pricing and possibly availability in some areas. Insurers have been forced to rethink their approach and become more selective about the risks they write. Similarly to the private insurance market's response to the severe hurricanes in 2004 and 2005, insurance companies may opt to scale back their Florida operations or spread out to other states. Already, more companies are avoiding specific areas of the state, diminishing the availability of coverage in the Tri-County region in particular.

Without legislative relief in sight, insureds will likely face rate increases. Less affordable insurance and a decline in availability sound eerily similar to the conditions that led to the increase in Citizens' market share earlier in the decade. The AOB crisis stands to undo some of the depopulation program's success, as insureds are forced back into the program. As Exhibit 4 illustrates, assumptions have been decreasing since 2014, around the same time AOB issues became more severe. The decline undoubtedly reflects the smaller pool of policies available, but it can also be linked to issues associated with AOB claims. Unsurprisingly, assumptions from Citizens have decreased as the average homeowners' direct loss ratio has increased. Not only have assumptions from Citizens slowed, but the company itself is also not immune to the impact of AOB claims, which have deteriorated its operating results as well.

Exhibit 4
Citizens' Policies in Force and Depopulation Program
(Thousands)



Source: https://www.citizensfla.com

A.M. Best Rating Implications: Careful Scrutiny

A.M. Best continues to diligently monitor the state of Florida's property insurance market, placing careful consideration on several areas to determine appropriate issuer credit ratings for Florida-based companies. Owing to concerns about the hurricane-prone nature of the state, our analytical process entails a rigorous examination of a carrier's ability to populate and evaluate comprehensive property risk data that provides a clear understanding of the potential frequency and severity of loss. Risk characteristics and key assumptions that are built into the risk selection process are discussed at length to gauge risk appetite and pricing sophistication, not only for hurricanes, but also as they relate to the AOB environment.

A critical component of our evaluation of Florida-based companies is the review of their reinsurance structure. We evaluate a program based on its ability to mitigate not just one severe hurricane, but multiple events in the same year, stressing current results and projections to account for potential scenarios. This step is important, given the Florida property writers' typically high gross probable maximum losses from a modeled hurricane. We examine the ability of all rated entities to manage this exposure and mitigate potential losses.

Moreover, the varied nature of longevity and experience with Florida writers requires additional analysis, specifically as it relates to new and take-out companies. A.M. Best reviews a company's underwriting track record to measure operating performance capability as it relates to pricing, coverage, risk selection, and the appropriateness of reinsurance. The projections of newly formed companies with a limited historical record are subject to rigorous examination. Determining the effectiveness of risk management without years of performance history is a particularly difficult endeavor, so projections are scrutinized and assumptions evaluated for appropriateness and likelihood. The rating process also entails careful consideration of untested business models, especially in relation to current market trends.

A.M. Best expects rated entities to proactively address emerging issues, such as those resulting from the assignment of benefits. Though the Florida market is rightfully concerned with hurricane exposure, companies cannot lose sight of other threats, especially those for which severity can be more uncertain. The AOB environment is a unique situation, and a solid enterprise risk management program that focuses not only on current risks but also on various emerging risks is essential. Although companies have implemented overall mitigation strategies that offer some potential for relief, the AOB threat remains.

We believe the rated entities in the Florida property market are adequately managing their ongoing exposure to these negative market trends, particularly as they relate to the companies' current A.M. Best ratings. However, further escalation of losses resulting in deterioration in risk-adjusted capital could result in negative rating pressure.

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Oldwick, NJ
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WORLD HEADQUARTERS
1 Ambest Road, Oldwick, NJ 08858
Phone: +1 908 439 2200

WASHINGTON
830 National Press Building, 529 14th Street N.W., Washington, DC 20045
Phone: +1 202 347 3090

MEXICO CITY
Paseo de la Reforma 412, Piso 23, Mexico City, Mexico
Phone: +52 55 1102 2720

LONDON
12 Arthur Street, 6th Floor, London, UK EC4R 9AB
Phone: +44 20 7626 6264

DUBAI*
Office 102, Tower 2, Currency House, DIFC
P.O. Box 506617, Dubai, UAE
Phone: +971 4375 2780
*Regulated by the DFSA as a Representative Office

HONG KONG
Unit 4004 Central Plaza, 18 Harbour Road, Wanchai, Hong Kong
Phone: +852 2827 3400

SINGAPORE
6 Battery Road, #40-02B, Singapore
Phone: +65 6589 8400

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