



Demotech, Inc.

July 26, 2022

David Altmaier
Commissioner, Office of Insurance Regulation
Financial Services Commission
State of Florida
200 East Gaines Street
Tallahassee, FL 32399-0305

Commissioner Altmaier,

Demotech writes in response to your correspondence dated July 21, 2022. Through this letter, we provide responses to your questions. We also provide clarifications regarding the clear misunderstandings about Demotech included in the letters from OIR and the Florida Chief Financial Officer.

Demotech is a widely-accepted rating agency that has reviewed and rated insurance companies since 1989. Government Sponsored Enterprises (GSEs), including the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), have accepted Financial Stability Ratings[®] (FSRs) since 1989 and 1990 respectively. With GSE recognition, residential mortgage lenders will accept any insurance company rated by Demotech to insure a consumer's home, so long as the insurer meets the GSEs required ratings level. More recently, the Securities and Exchange Commission (SEC) recently registered Demotech as a Nationally Recognized Statistical Ratings Organization (NRSRO).

In Florida, Demotech has rated and reviewed property and casualty insurance companies writing homeowners insurance for the past 26 years. Invited to do so by the State of Florida in 1996, Demotech has consistently invested the necessary time and resources to understand the Florida insurance market when no other rating agency would do so. Due to Demotech's work and investment in Florida, for the past 26 years, many Floridians have been able to purchase homeowners insurance and meet insurance requirements needed to own their homes.

Demotech has conducted its ratings reviews in an open and transparent manner across the nation, operating in a competitive manner in each state where it operates. GSEs vital to the real estate market recognize and accept Demotech's FSRs of insurers. Demotech is proud to conduct its work in a professional and consistent manner, utilizing commercially accepted best practices at all times. Based on some of the statements in last week's letters, Demotech provides you with some additional background information on its work, process, and rating methodology.

Background

Demotech has a unique history in Florida. In 1996, Florida Commissioner of Insurance Tom Gallagher worked with the industry and the legislature to depopulate the Florida Residential Property Casualty Joint Underwriting Association (JUA). In order to do so, Florida needed additional insurers that Fannie Mae or Freddie Mac recognized so that the additional insurers could sell homeowners insurance that would be accepted by mortgage lenders. Fannie Mae has accepted



FSRs since 1989, and Freddie Mac has accepted them since 1990. During this time period, the legacy rating agencies had a significant presence in Florida. However, as Demotech understands it, they were unwilling or unable to review and rate the carriers focused on depopulating the JUA. Commissioner Gallagher asked Demotech to consider rating new entrants to the Florida market. Demotech studied the situation and agreed to do so. As a result of our consistent processes and demonstrated expertise, and the experience and professionalism of our long-tenured and credentialed staff, Demotech now rates approximately 60% of the market share in the state as well as more than 450 entities nationwide.

As an initial point of clarification, Demotech rates insurance companies and not insurance markets. Demotech does not provide ratings regarding the Florida Insurance Guaranty Association, the Florida Hurricane Catastrophe Fund, or Citizens Property Insurance Corporation. Demotech may consider the impact of these entities if their operation or stability would affect any insurance company that Demotech rates. As noted below, Demotech has commented on issues of Florida law that impact the financial stability of insurance companies operating in Florida. However, Demotech does not rate or rank insurance markets.

Demotech Review Standards

Demotech uses an effective and documented review process to determine and assign its ratings, often relying on some of the same information that OIR uses to oversee insurers in its marketplace. Demotech conducts significant due diligence before issuing any insurance company rating. Demotech's rating process includes reviews of the following:

- Quarterly financial statements filed with the OIR and the National Association of Insurance Commissioners;
- Preliminary and final reinsurance programs, the insurer's catastrophe modelling results, the insurer's use of a captive, catastrophe bond(s), insurance linked securities, or parametric-triggered protection;
- The annual management's discussion and analysis;
- The statement of actuarial opinion regarding loss and loss adjustment expense (LAE) reserves;
- Catastrophe response plans, disaster recovery plans; and
- Rate level adequacy.

Demotech communicates with rated entities as often as necessary, sometimes on a daily basis. It has additional communications when the carrier finalizes matters that are discussed, such as rate revisions, changes in underwriting criteria, or changes to management or business models. It interacts with the insurer, reinsurance broker, and sometimes the insurer's catastrophe modelling company of choice on multiple occasions per year. Any discussion of the insurer's use of a captive, catastrophe bond(s), insurance linked securities, or parametric-triggered protection may result in numerous additional interactions.



In Demotech's rating process, each carrier is provided an opportunity to discuss the issues that impact the assigned FSR. In Florida, over the past several years, although pre-tax profitability has generally been elusive, many of the revised business models and action plans have been successful and many carriers have sustained FSRs of A or better.

When an insurance company changes its business model or encounters changes in its operating environment (positive or negative), Demotech must reevaluate the assigned FSR. In all instances, Demotech communicates with the insurer to understand how and why it believes that its revised business plan mitigates historical operating losses or, preferably, returns the carrier to a level of pre-tax underwriting profitability. In some instances, Demotech may recognize additional capital infusions to support the implementation of a revised business model. Subsequent to the carrier's implementation of its revised business model, actual operating results are compared to anticipated operating results and the analysis is discussed with company management. When appropriate, given the individual circumstances of a rated insurer, our evaluation process subsequent to an insurer's implementation of a remedy has reflected a timeframe sufficient to evaluate the impact of the remedy implemented by management.

Through Demotech's appeal process, insurers are afforded an opportunity to correct errors, omissions, or misperceptions, or provide additional information for Demotech's consideration. Additional reviews permit, but do not require, Demotech to evaluate revisions to business plans or capital infusions over a reasonable period of remedy, but such considerations are in Demotech's discretion based on an individual company's circumstances. Permitting a timeframe to institute a remedy is distinct from an appeal, and is not guaranteed. Since the issuance of rating notification letters to companies, our analysts have been communicating with every insurer that requested a discussion, and receiving and considering additional information.

Insurers choose to work with Demotech, and Demotech must meet the standards and requirements of GSEs in order to offer a ratings service to insurance companies. Since the acceptance of FSRs by a GSE in 1989, Demotech has communicated its rating standards and methodology to the insurers that it reviews and rates. Demotech has also provided each insurer with an opportunity to discuss issues that impact rating actions through the appeal process. Despite multiple opportunities and remedies to sustain an FSR, some insurers are unable to do so (often due to reasons comparable to those OIR referred for Enhanced Monitoring, as referenced in the OIR Property Insurance Stability Report dated July 1, 2022).

Demotech concurs with OIR – rating standards should be applied objectively and consistently. As noted above, Demotech has done so since 1989. Some carriers have successfully navigated the difficult residential property insurance marketplace to effect the necessary improvements and sustain the assigned FSR. Others have not. These divergent outcomes reflect the balance and effect of multiple factors impacting a state's residential insurance marketplace, including positive or negative external factors (such as weather, litigation or legal/regulatory requirements), the respective capabilities and competencies of each company's management team, and investment markets. Analysts know, outcomes affect ratings.



Having responded to some of the contents of OIR's letter, Demotech addresses the remaining issues: balance sheet integrity, notifications of ratings revisions, profitability, our status as an NRSRO, legislative changes or actions, and protection of Floridians from harmful, unilateral action.

Balance Sheet Integrity and Notifications of Rating Changes

One key factor is Demotech's preference for adequate loss and LAE reserves in an insurer's balance sheet. Adequate loss and LAE reserves are a higher standard than reasonable loss and LAE reserves. Further, when reported income is based upon adequate loss and LAE reserves, the quality of reported earnings is more likely to withstand the tests of time, such as one-year and two-year loss and LAE development ratios. Admittedly, in a marketplace with disproportionate levels of litigation, this metric can be difficult for insurers to attain.

Regarding Demotech's most recent notification of rating revisions, each carrier received previous communications from Demotech addressing the need to strengthen their balance sheets as well as other issues negatively impacting our review. The strengthening may include a capital contribution to enhance surplus, a capital contribution to boost loss and LAE reserves toward adequacy, a combination of both, or other remedies. Carriers that elected to stair-step toward reserve adequacy, relied on underwriting revisions or rate increases to drive improvements in their balance sheet, or opted for a process that elongated the time requirement for a meaningful revision and remedy to their balance sheet may not have addressed concerns in a timely manner.

As noted above, over the past several years, many carriers have implemented remedies and corrective action plans and successfully executed their revised business plans or remedies to maintain or improve their ratings. Some companies were successful in enhancing their financial position, while others were not.

Profitability

Regarding profitability, insurers of all types view pre-tax profitability as an important goal because it is the path to organic growth of surplus and facilitating growth. With Florida's residential property insurance marketplace exhibiting a disproportionate level of litigation relative to claims opened, profitability has been elusive, particularly since 2017. Concurrently, Florida's disproportionate level of litigation has contributed to significant increases in the cost of reinsurance, thereby reducing the net premium available for non-catastrophe attritional claims while increasing the premium levels paid by consumers.

Another reduction to the net premium levels retained by carriers has been contributions to the Florida Hurricane Catastrophe Fund's (Cat Fund) Rapid Cash Build-up program. Since its inception in 2009, the Rapid Cash Build-up program has annually enhanced the position of the Cat Fund while reducing the net premium available to residential property insurance carriers focused on Florida. Carrier contributions to the Cat Fund are increasing, thus impacting the profitability of participating Florida insurers by reducing their revenue.



Of course, profitability can trigger a rating change. Where applicable, whenever an insurer experiences a downturn, we advise the impacted carrier of the need to enhance their respective balance sheet, move toward profitability, or otherwise enhance their financial stability. If an insurer is unable to report a pre-tax profit from time-to-time and also loss and LAE reserves at an adequate level, then it may be advised that it no longer possesses characteristics of an insurer with an FSR of A, yet may be a candidate for an FSR of S. Carriers assigned an FSR of S meet or exceed Demotech's reinsurance requirements, possess a strong balance sheet, and exhibit a survival rate at an above average level of security based upon independent studies of insurer survival rates. In response to this level of security provided, an FSR of S has been adopted as an acceptable threshold in several situations by the insurance industry.

Demotech as NRSRO

Regarding Demotech's registration as an NRSRO, the SEC granted registration on July 11, 2022. Respectfully, what was presented in Demotech's application to the SEC's Office of Credit Ratings (SEC OCR) was inaccurately characterized in the correspondence dated July 21, 2022. Demotech's procedures as an NRSRO were developed consistent with its past practice and met the standards required for registration with the SEC OCR. A component of the independence required to secure registration as an NRSRO is Demotech's demonstrated capability and willingness to resist efforts to take action inconsistent with its own established methodology and processes. The methodology allows for discussion and appeals to correct errors or misperceptions; however, it is not our responsibility to recommend a remedy or provide time to implement corrective action. Remedies must be developed by carriers. We review and opine on outcomes.

Florida Litigation Level and Demotech's Ratings

Demotech has studied the Florida insurance market and trends for decades, and is always willing to be a positive resource for stakeholders. On March 23, 2022, Demotech wrote to the Florida state leadership to express its views regarding the disparate, disproportionate level of litigation and the increasing non-catastrophe claim frequency that were documented by the NAIC Market Conduct Annual Statement data in your letter of April 2, 2021 and contained in the chart on page 3 of the OIR's Property Insurance Stability Report dated July 1, 2022. Although 2021 data is not considered finalized, it showed that Florida represented seven percent of nationwide homeowners' claims, yet was 75 percent of the country's homeowners-related lawsuits. Demotech expressed its view that Florida's homeowner's litigation environment must be dramatically and rapidly improved in order to facilitate profitability for Florida insurers. In Demotech's view, doing so would stabilize premium levels in the residential property insurance market, mitigate future rate revisions, address the availability and affordability crises that impact Floridians, provide carriers with a possibility of profitability and organic surplus growth, and, perhaps most importantly, re-engage with and convince the reinsurance community to increase capacity at a reduced cost.



Conclusion

Demotech has worked diligently to be a positive force in the resurrection and sustenance of the Florida residential property insurance marketplace that was devastated by Hurricane Andrew. Since 1996, Demotech has consistently applied its rating methodology and appeal process to all rated insurers. Our process does not guarantee every carrier's financial success, nor does our process guarantee carriers an FSR at a level that they desire or require.

Through 2016, Demotech-rated carriers in Florida reported positive retained earnings. While operating losses have become more prevalent after 2017, Demotech's rating methodology and appeal process have not changed – despite challenges that have mounted due to Florida's disproportionate litigation levels. Even with these differing profitability environments, some Florida insurers have been able to retain FSRs of A.

As our efforts to address the actionable appeals regarding proposed rating action were suspended to prepare responses to state officials, Demotech has postponed its previously scheduled release date of July 26, 2022 and has contacted the carriers that have not yet submitted a response.

In sum, Demotech disagrees with OIR's portrayal of our company, rating process, and client communications, and takes issue with the premature, public dissemination of such misinformation. Nevertheless, Demotech continues its review process for all Florida-focused carriers consistent with its established processes, and will take such rating actions as it deems appropriate in support of Florida homeowners.

In Florida's residential property insurance marketplace, challenges continue to emanate from disparate, disproportionate litigation. Our FSRs must recognize the financial impact of those challenges on the carriers that we review and rate.

Demotech trusts that these clarifications afford OIR with a more complete and accurate description of its rating process and how it significantly benefits the Florida homeowners' insurance marketplace. Demotech's team is available to discuss any of these issues with you at your convenience.

Very truly yours,

Joseph L. Petrelli, ACAS, ASA, MAAA (MBA)
President and Co-founder