Demotech, Inc.

Guidance on Financial Stability Ratings® and Catastrophe Reinsurance Program Reporting for Florida Property Insurers

March 2010

DRAGONFLY:
300 MILLION YEARS OLD

T-REX:
EXTINCT

Nature knows size and survival are independent.

Demotech, Inc. had to prove that to the insurance industry.

Introduction

Demotech has contributed to the stabilization of the property insurance market in the State of Florida since 1996. Our efforts have focused on the assignment of Financial Stability Ratings® (FSRs) to financially stable insurers, including start-ups and established insurers.

Over the past several years, legislative and statutory changes, turmoil in the global financial markets, a decline in residential real estate values and other economic factors have resulted in an increased focus on the financial stability of Florida's property insurers. In our efforts to continue to assist financially stable insurers, our on-going, quarterly review process was enhanced to include frequent communication with insurers as well as interested third parties. This increased communication focused on our assignment of an initial Financial Stability Rating® as well as an insurer's ability to sustain and maintain its FSR going forward.

Our quarterly review process is not limited to criteria surrounding the appropriateness of a company's catastrophe reinsurance program. To familiarize insurers and interested third parties with our expectations related to insurers writing property insurance in Florida, we prepared this discussion document to address selected components of our quarterly and annual review process and criteria. Unless specifically addressed, all references pertain to our on-going quarterly or annual review process. The term ***annual review*** is applicable for both the calendar year financial statement review and the affirmation of FSRs over a twelve month rating and review cycle.

Financial Benchmarks, Ranges and Minimums

Demotech does not mandate specific financial benchmarks, acceptable ranges or minimums for policyholders' surplus, admitted assets, risk-based capital, leverage ratios, PML modeling parameters, net catastrophe retention levels or other aspects of financial, operational or capital adequacy performance measures. In other words, the initial assignment or affirmation of a Financial Stability Rating® is contingent upon our interpretation of the overall financial stability of the insurer. We believe management's ability to consistently report acceptable operating results, including surplus growth and the maintenance of capital adequacy, is the culmination of sound management practices.

Capital Adequacy

Although Demotech does not establish internal minimums or publish our proprietary benchmarks, objective measures of capital are available. Sources include the statutes of various jurisdictions and Risk-Based Capital, as determined by the National Association of Insurance Commissioners (NAIC). Risk-Based Capital is reported in the statutory annual statement and is available to interested third-parties. Similarly, the consequences associated with the relative levels of Risk-Based Capital should be well-known to insurers. Accordingly, when an insurer calculates and reports total adjusted capital that does not exceed the authorized control level Risk-Based Capital by a 3:1 ratio, it is reasonable to assume that management is developing an action plan to improve capital adequacy.

In addition, rote acceptance of the absolute surplus level of an insurer does not necessarily provide an appropriate evaluation of the adequacy of the reported surplus. Demotech considers other components of the balance sheet, statement of income and statement of cash flow as significant keys to understanding, evaluating and accepting the reported surplus as an accurate estimate of available surplus. It has been our practice to expand our standard review process whenever an insurer reports an overall decrease to surplus that is greater than 10% of the prior year-end surplus.

Similarly, insurers operating at, or near, the state minimum surplus level and those with net catastrophe retentions greater than 15% of surplus (first event, pre-tax) have received additional inquiries during our quarterly review and analysis process. Demotech's review and analysis process respects insurers that maintain surplus at a level that can absorb operating losses including potential catastrophe events, downturns that impact investment income and the values of investments, and other factors that have a negative impact on surplus, without the need to receive a capital contribution to remain financially stable. In our opinion, although the ability to obtain post-event capital infusions is a valid consideration, it is not equivalent to intrinsic balance sheet integrity.

Liquidity

Available cash and invested assets provide insight into the liquidity of admitted assets as well as the flexibility in the insurer's claims paying ability. A liquidity ratio, defined as cash and invested assets to total liabilities, of 1:1 or greater is our expectation. An insurer with a liquidity ratio below 1:1 is likely to be scrutinized prior to a carrier with a liquidity ratio of 1:1 or greater.

Concerns regarding the liquidity of admitted assets were heightened in late 2008 due to reports that the Florida Hurricane Catastrophe Fund (FHCF) might experience difficulty raising capital in a timely manner following a catastrophic event. It seems reasonable to us that our review include an evaluation of the carrier's liquidity position, the quality of the underlying assets and the company's contingency plan for providing stop-gap measures for a period of time up to one year as long as the FHCF relies upon post-event funding. We view supplemental measures that companies have taken to ensure adequate liquidity, which include securing letters of credit, formal lending agreements with affiliates and other resources, as a positive reflection of management's ability to access adequate cash flow if needed.

Loss and Loss Adjustment Expense Reserves

A key indicator of management's commitment to financial stability, solvency and capital adequacy is its desire and ability to record adequate loss and loss adjustment expense reserves (loss reserves) on a consistent basis. Adequate loss reserves meet a higher standard than reasonable loss reserves. Demotech views adverse loss reserve development as an impediment to the acceptance at reported value of current, and future, surplus. From our perspective, any amount of adverse loss reserve development on a consistent basis is unacceptable as it may be indicative of management's ability or willingness to properly estimate ultimate incurred losses.

Unearned Premiums

A key leverage ratio is total liabilities to surplus. Our preference is to see companies report a total liabilities to surplus ratio of less than 3:1. A ratio greater than 3:1 will subject the company to additional review and analysis.

For new companies, and those companies experiencing significant premium growth, unearned premiums can represent a significant portion of total liabilities. Lagging earnings, coupled with the inability to defer acquisition costs, create pressure on statutory surplus. If the company is posting underwriting losses while continuing to grow, the negative future impact to surplus may be compounded. In these situations, we need to understand the rationale and plan for outgrowing poor underwriting results. Adequacy of pricing at the policy level, private sector reinsurance costs and loss reserve development are important components of our evaluation.

Premium to Surplus Leverage

The NAIC's published IRIS ratios provide direction on acceptable ranges of gross premium written (GPW) and net premium written (NPW) to surplus ratios. For example, to avoid an exceptional ratio, the GPW to surplus ratio should be less than 9:1, with the NPW to surplus ratio at or below 3:1. Although our guidelines are not identical to these, we review the premium to surplus leverage ratios as a component of our overall evaluation.

In our opinion, a GPW to surplus ratio in excess of 6:1 should subject the company to greater scrutiny during the review process. Likewise, a NPW to surplus ratio greater than 3:1 should subject the company to greater scrutiny during our review. We may be comfortable with higher ratios when the insurer can demonstrate that a contributing factor to the higher ratio is relative rate adequacy.

Underwriting Results and Other Underwriting Expenses Incurred

Although Demotech does not expect a company to record and report an underwriting gain in each quarterly reporting period, a component of our review process is the evaluation of underwriting results. Any company recording an underwriting loss greater than 10% of prior year surplus will be subject to a more detailed review of current operating results. Chronic underwriting losses during a period with a limited number of catastrophe events may prompt a request for information regarding rate making, policies in-force exposure information, reinsurance changes, or other information relative to the current and future anticipated expense levels.

When an insurer has selected a business model that reflects significant administrative fees, commissions or fees to affiliated or non-affiliated managing general agencies or third party administrative firms, the insurer will need to provide insight on how these components impact its operating results as well as its business model. Since this business model diverts revenue streams from the insurer to other entities, this structure might hamper the ability of the insurer to grow surplus through operations.

A contributing factor to the other underwriting expense ratio is the cost of reinsurance. Many Florida companies do not receive significant ceding commission and, based upon perceptions or realities of rate adequacy, may cede relatively more premium to their reinsurers. The result is an increase in other underwriting expense because there are fewer net premium dollars to absorb underwriting expenses.

Recently, several Florida companies have modified their formal administrative and commission agreements to reduce underwriting expenses paid to third parties, thereby retaining relatively more premium in the insurer. Demotech prefers approaches that retain premium and capital in an insurer. We believe this can be an effective method for providing relief to underwriting results, while simultaneously enhancing liquidity and surplus.

Catastrophe Reinsurance Program

As referenced earlier in this document, a company with a net catastrophe retention greater than 15% of prior year surplus (first event, pre-tax) will trigger a more detailed review regarding their relative surplus position and catastrophe reinsurance program. Demotech does not mandate an absolute level of net catastrophe retention relative to surplus. We believe that the variables inherent in evaluating the appropriateness of each insurer's catastrophe reinsurance program preclude the establishment of benchmarks. However, we will continue to provide feedback on aspects of company-specific catastrophe reinsurance programs that are pertinent to our review.

To obtain objective and consistent information, we have developed ***Exhibit A*** (see page 6) as part of our data call for information on catastrophe reinsurance programs. We will require each company to complete our most current ***Exhibit A*** prior to an upcoming storm season. ***Exhibit A*** provides objective information regarding critical components of a company's catastrophe reinsurance program. The critical components include, but are not limited to, the insurer's selected parameters used in modeling its probable maximum loss and the net catastrophe retentions for specified event return times.

Much of the following information will be collected through ***Exhibit A*** prior to each storm season.

Probable Maximum Loss (PML)

Demotech is not requiring nor mandating an insurer to use specific PML modeling features in designing and purchasing its catastrophe reinsurance. ***Exhibit A***, fully completed, will allow us to compare event return times under the most conservative parameters to the parameters selected by the company.

Demotech has no preference regarding the use of RMS, AIR or any other generally accepted PML modeling software application or weighted composites based on a combination of generally accepted PML modeling applications. Demotech's required key return period is at least a 100 year event. In addition, we prefer more conservative parameters to less conservative parameters.

In addition to the parameters that the insurer selected in its PML modeling, Demotech will review the results based upon the conservative parameters - occurrence, near-term, loss amplification, and secondary uncertainty. We will continue to use this data as a component of our overall review of a company's catastrophe reinsurance program.

Illustrative Tower Graph

Demotech expects to receive an illustrative tower graph of the insurer's catastrophe reinsurance program. We believe that the illustrative tower graph is an efficient method for obtaining this information. The tower graph should include specific information on net catastrophe retentions (pre-tax) for first, second and third events (if applicable), reinstatement premium protection, and any company co-participation retentions within the FHCF layers. Demotech appreciates that the reinsurance in place for second and third events will not necessarily match the cover provided for a first event with the 100 year event return. However, we will review and analyze the program that the insurer has in place to address multiple events.

Temporary Increase in Coverage Layer (TICL)

When carriers purchase private sector reinsurance from financially stable property reinsurers, there is an expectation that the meritorious demands of the cedants will be honored in a timely manner, in the normal course of business. In contrast to pre-event funding, the Florida Hurricane Catastrophe Fund is a reimbursement-based mechanism. Accordingly, it must issue bonds to obtain funds to reimburse its clients. Given this distinction, insurers opting to purchase reinsurance in TICL that also desire to remain eligible for a Financial Stability Rating® of A, *Exceptional,* or better must demonstrate sufficient liquidity and capacity to honor meritorious claims during a reasonable period of time, permitting the Florida Hurricane Catastrophe Fund to obtain sufficient funds to initiate reimbursements associated with TICL.

To meet Demotech's preliminary criteria related to liquidity and capacity, an insurer should review its latest available financial statement as regards the following questions. The amounts referenced will be found in an insurer's 2009 annual statement and quarterly statements during 2010.

1. Is the liquidity ratio (cash and invested assets to total liabilities) greater than 1.0?
2. Is the ratio of total liabilities to policyholders' surplus 3.0 or less?
3. Are the 1-year and 2-year loss development numbers shown in Schedule P – Part 2 Summary both favorable (negative)?

Carriers that do not meet the above criteria should be prepared to present detailed information related to their assumptions, forecasted business plan and alternative funding sources if they expect Demotech, Inc. to provide full credit for TICL.

Even if a company meets our preliminary eligibility criteria and elects to utilize TICL, it must prepare and submit its rationale for choosing TICL over private sector reinsurance. In addition, we require financial projections addressing, to our satisfaction, the company's ability to cash-flow losses related to an event that impacts the TICL layer.

Carriers that meet our preliminary eligibility criteria should not assume that their rationale and financial projections will be accepted as submitted. We will advise each company that meets preliminary eligibility criteria and elects to utilize TICL as quickly as we can.

Supplemental Narrative Information

In addition to the data call and the illustrative tower graph, we expect management to provide sufficient information to permit us to understand management's interpretation of its financial statement integrity as well as its catastrophe reinsurance program. Some of the items that have been included in previous discussions and narratives include, but are not limited to, the following topics:

- Information on any structured quota share reinsurance agreements as applicable
- Participation in pools or other corporate structures impacting the company's catastrophe reinsurance program
- Approved and pending rate increases including a history of rate changes for the immediately preceding three calendar years and pending changes anticipated in the current year
- Specific issues concerning changes and modifications to the company's property book of business, such as plans limiting geographic concentration of risk, sinkhole exposure and other pertinent issues relevant to underwriting results
- Approved or pending legislative and regulatory changes significantly impacting the company
- Participation in a Citizens depopulation program.

Summary

This document outlines Demotech's expectations relative to some of our data needs. With respect to providing Demotech information on the catastrophe reinsurance program, we require the following:

1. Properly completed ***Exhibit A*** Data Call
2. Illustrative Tower Graph
3. TICL information, if applicable
4. Supplemental Narrative Information.

The above items, and such other information as we may deem useful and necessary to our efforts, will be requested each year, in advance of the storm season. We appreciate that the timing of our request may mean the company's catastrophe reinsurance program will not be final. We expect to complete our review of the company's proposed catastrophe reinsurance program prior to May 1.

There will be two ***Exhibit A*** Data Calls. The first, ***Exhibit A – Proposed Data Call,*** will be issued in early April and will be due to us in mid April. The second, ***Exhibit A – Final Data Call***, will be issued in early June and will be due to us in mid June. Our objective is to develop a standard format to facilitate data collection in order to reduce the time and effort needed to respond to our requests. We continue to request the information we deem necessary to enable us to assist financially stable insurers. The purpose of this discussion document is to provide insight and communicate many of the elements critical to our review process.

Concluding Statements

Included throughout this document are references to some of our standards that we consider when reviewing a company. These standards are not new and have been consistently utilized as part of our overall evaluation and review process. To summarize, the following references appeared in this discussion document:

- Risk-Based Capital Ratio – A Risk-Based Capital ratio, as represented by total adjusted capital to the authorized control level risk-based capital, of 3:1 or higher will be viewed favorably.
- Policyholders' Surplus – For a financial reporting period, an overall decrease to surplus that exceeds 10% of the prior year-end surplus merits further review and analysis.
- Net CAT Retention to Surplus – Net CAT retentions (first event, pre-tax) that exceed 15% of the most recently reported surplus are viewed as significant and may result in further review and analysis.
- Liquidity – A liquidity ratio, cash and invested assets to total liabilities, of 1:1 or greater will be viewed favorably.
- Quarterly and Year-end Reserve Development – Any adverse reserve development will be viewed negatively.
- Liabilities to Surplus Ratio – A liabilities to surplus ratio not exceeding 3:1 will be viewed favorably.
- Premium Written to Surplus – For companies writing property business in Florida, Demotech believes a gross premium written to surplus ratio greater than 6:1 or a net premium written to surplus ratio of 3:1 or more should result in a request for additional information.
- Underwriting Loss – For a financial reporting period, we view a cumulative reported underwriting loss which represents more than 10% of the prior year-end surplus as meriting further review and analysis.

These criteria are some of the objective evaluation criteria applied to each insurer writing property business in Florida. These criteria are not a safe harbor or bright-line indicator for acceptable financial performance. Demotech reviews and evaluates quantitative and qualitative data on each company we rate. Regarding supplemental information, every entry, whether related to financial data, footnotes, etc. in any quarterly financial statement, annual statement, reinsurance treaty, independent audit, examination report by a department of insurance or business plan as well as information in the public domain or otherwise submitted to Demotech, Inc., is reviewed and interpreted. If questions arise or clarification is required, Demotech expects management to respond in a timely manner.

Demotech believes that financial stability is independent of size. We believe well-managed, properly reinsured, regional Property and Casualty insurers can be as financially stable as larger insurers.

If you have questions, or would like specific information related to your company's situation, you can contact Bob Warren, Client Services Manager, or Barry Koestler, Chief Ratings Officer, at 614 761-8602.

EXHIBIT A - PROPOSED Data Call
Due April 15, 2010
Probable Maximum Loss (PML) Information Request - 2010 CAT Season

SECTION I - Company Selected PML Model Options

Company Name ____________________ NAIC # __________

Intermediary/Broker ____________________

PML Model Used:		PML Model Version/Weighting	Internally Licensed
RMS			
AIR			
Other: Specify			
Blended			

	Occurrence or Aggregate	Long Term or Near Term	Loss Amplification/ Demand Surge	Secondary Uncertainty	Storm Surge
PML Model Options Included:					

Total Insured Value (Wind Only) $ -
as of
Number of Policies (Wind Only)
Projected TIV as of September 30, 2010 (Wind Only) $ -

		Col. 1	Col. 2	Col. 3 (Cols. 1-2=3)	Col. 4	Col. 5
Event Return Time:	Selected	Probable Maximum Loss (PML)	Reinsurance Recoverables	Net Retention	Company Co-Participation	Reinstatement Cost to Reinstate Layers
20				$ -		
50				$ -		
75				$ -		
100				$ -		
150				$ -		
Other:				$ -		

SECTION II - Demotech Selected PML Model Options - Long Term

Total Insured Value (Wind Only) $ -
as of
Number of Policies (Wind Only)
Projected TIV as of September 30, 2010 (Wind Only) $ -

		Col. 1	Col. 2	Col. 3 (Cols. 1-2=3)	Col. 4	Col. 5
Event Return Time:	Selected	Probable Maximum Loss (PML)	Reinsurance Recoverables	Net Retention	Company Co-Participation	Reinstatement Cost to Reinstate Layers
20				$ -		
50				$ -		
75				$ -		
100				$ -		
150				$ -		
Other:				$ -		

	Occurrence or Aggregate	Long Term or Near Term	Loss Amplification/ Demand Surge	Secondary Uncertainty	Storm Surge
PML Model Options Included:	Occurrence	Long Term	YES	YES	NO

SECTION III - Demotech Selected PML Model Options - Near Term

Total Insured Value (Wind Only) $ -
as of
Number of Policies (Wind Only)
Projected TIV as of September 30, 2010 (Wind Only) $ -

		Col. 1	Col. 2	Col. 3 (Cols. 1-2=3)	Col. 4	Col. 5
Event Return Time:	Selected	Probable Maximum Loss (PML)	Reinsurance Recoverables	Net Retention	Company Co-Participation	Reinstatement Cost to Reinstate Layers
20				$ -		
50				$ -		
75				$ -		
100				$ -		
150				$ -		
Other:				$ -		

	Occurrence or Aggregate	Long Term or Near Term	Loss Amplification/ Demand Surge	Secondary Uncertainty	Storm Surge
PML Model Options Included:	Occurrence	Near Term	YES	YES	NO

SECTION IV - Estimated Ceded Premium to Estimated Gross Premium for 2010

Estimated Total Gross Premium Written for Calendar Year 2010: $ -
Estimated Total Reinsurance Ceded Premium for Calendar Year 2010: $ -
% Ceded Premium to Gross Premium Written:

Demotech, Inc. Milestones

1985 Founded by Joseph L. Petrelli and Sharon M. Romano to offer actuarial services.

1986 First to issue Financial Stability Ratings® (FSRs) for health maintenance organizations (HMOs).

1987 First to issue FSRs for public entity liability self-insured pools through the development of our Management Audit Process.

1989 First to have Property and Casualty insurance company rating process formally reviewed and accepted by Fannie Mae. An FSR of A or better eliminates the need for property insurance cut-through endorsements.

1990 First to have Property and Casualty insurance company rating process formally reviewed and accepted by Freddie Mac.

Began offering Property and Casualty insurance companies and Title underwriters loss cost analysis and rate, rule and form filing assistance.

Responded to the National Association of Insurance Commissioners (NAIC) requirements for Property and Casualty insurers to submit Statements of Actuarial Opinion related to loss and loss adjustment expense reserves concurrent with the 1990 Property and Casualty annual statement.

1992 First to analyze the financial position for each Title underwriter.

1993 First to have Property and Casualty insurance company rating process formally reviewed and accepted by HUD.

1994 Fannie Mae issued Title underwriting guidelines, naming Demotech as an approved Title underwriter rating service.

1995 First to promulgate Commercial Real Estate Recommendations (CRERs) to provide additional financial due diligence of Title underwriters involved in larger real estate transactions.

1996 Contacted by the Florida Office of Insurance Regulation (OIR) when the property insurance market encountered newly established insurers that did not meet traditional rating requirements. Working with the Florida OIR, Demotech developed evaluation procedures for the assignment of FSRs to newly formed Property and Casualty companies.

Coordinated the first seminar regarding the implementation of Statements of Actuarial Opinion for Title insurance companies on behalf of the Conference of Consulting Actuaries and in cooperation with the American Land Title Association (ALTA).

1999 Co-authored the Commerce Clearing House publication describing the evolution of the Canadian Title insurance industry.

2001 Completed the initial loss and loss adjustment expense review of the Iowa Finance Authority – Title Guaranty Division.

2002 Revitalized the Ohio Title Insurance Rating Bureau (OTIRB).

2003 Assisted the North Carolina Title Insurance Rating Bureau with the development and filing of Closing Services insurance product.

Assisted the OTIRB with its first rate revision since 1980.

2004 Published Serious about Solvency – Financial Stability Rating® Survival Rates 1989 through 2004. This article outlines the description of our analysis process, the assignment of FSRs and the survival rates of those ratings. This retrospective analysis indicates that insurers earning FSRs of A or better had survival rates at or above expectations.

2005 HUD approved Demotech's rating process for professional liability insurance under Notice H04-15, Professional Liability Insurance for Section 232 and 223(f) Programs.

2007 Designated as the "Official Research Partner" of Insurance Journal, providing research, actuarial and statistical support and collaborating on special joint reports pertaining to insurance industry performance and financial results.

Expanded operations into a new facility reflecting our increased capacity to serve the industry and our clients.

2008 Introduced Insurance Agents' Errors and Omissions Insolvency Gap Legal Defense Coverage.

2009 Expanded the Insolvency Gap Coverage to include indemnity as well as legal defense.

2010 Demotech, Inc. celebrates its 25th Anniversary!

Mission Statement

Demotech, Inc. will become the leading provider of innovative solutions to financial analysis issues by focusing our resources on niches presenting opportunity for corporate growth.

SERIOUS ABOUT SOLVENCY®

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