Demotech, Inc.

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President, CEO and Executive Director
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Tallahassee, FL 32303

Concerning: Downgrades of Demotech rated insurance carriers – Florida

Dear Barry,

Please recall that earlier this week I reached out to you to discuss an Inside P&C article discussing the opportunity for Citizens Property Insurance Corporation (Citizens) to shrink its policy count. I reached out to advise you that shrinking the policy count of Citizens might be more difficult than expected as Demotech would be downgrading several carriers in January, February and March 2020. Subsequent to our initial conversation, I have had conversations with yourself and other professionals within Florida's legislative or administrative structure.

This correspondence is intended to summarize, at a high level, the conditions that have resulted in this necessity. Concurrently, I enumerate remedies that could dramatically eliminate the impact of downgrades. My last remedy would be the most holistic solution, and it is one that I have been working on for many years. I note that none of the remedies, other than the last remedy, should be viewed as a 'safe harbor.'

The conditions that have resulted in the necessity

I begin by acknowledging that it is my hope that the legislative changes implemented in 2019 will be upheld in the courts as constitutional and provide relief to consumers, insurers, reinsurers and other stakeholders. However, the long-term favorable impact of the newly passed legislation are that …. long-term. The economics of the marketplace over the past several years have made it impossible for Demotech to sustain each of the Florida focused carrier that we review each quarter at a Financial Stability Rating® (FSR) of A, Exceptional. As you will see as you read this material, the ultimate irony is that insurers earning a Financial Stability Rating® (FSR) of S possess a level of financial stability that is well above average.

As we see the situation, market forces as well as carrier specific financial metrics have created an environment where insurers are impacted by:

- Insurer investor capital appears to be exiting rather than entering Florida
- Current holding company debt, infused to support growth, permit the strengthening of loss and loss adjustment expense reserves without a diminution of surplus, or otherwise support the implementation of business models, are at burdensome levels given the operating results, e.g. losses, of carriers that had to address the natural disasters of 2016 through

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2019. For some carriers, the dollar amount of debt is burdensome as well as the interest rate associated with the debt.

- In 2019, the cost of catastrophe reinsurance has been, and likely will be in the future, a financial shock to the income statements of carriers. The impact of the cost of cessions concurrently impacts the net dollars carriers retain to honor or defend the meritorious claims of their policyholders, and operating expenses, etc.
- Although carriers can "true up" reinsurance costs by making the necessary filings with the State of Florida Office of Insurance Regulation, the financial impact of paying higher reinsurance costs is short-term and the financial impact of "true up" is long-term. With timing being critical, the timing mismatch adversely impacts carriers, given the other conditions.
- The cumulative impact of carrier acceptance of rate revisions at a percentage change that eliminates the time, effort and expense for a hearing and decision, i.e., less than 15%, has had a cumulate impact over the past several years. Example: an insurer that accepts a 14.9% rate increase four years in a row, when it needs a 20.0% rate increase in each of those four years will have secured a compound rate increase of 176%; however, it should have had a compound rate increase of 207%. At the end of four years, its rates are approximately 15% below where they should be.
- Demotech requires carriers to book "adequate" loss and loss adjustment expense reserves. In an operating environment characterized by stability of claims procedures, protocols and practices, unblemished by a continuum of judicial decisions that revised the claim settlement paradigm, this was all but in place. Then, the AOB decision, Sebo, Johnson and others revised the claim settlement landscape and set insurers and the actuaries they depend upon on their heels.
- Over the past several years, the revised rules of engagement for claims settlement, as set by the judiciary, have had an undue impact because the natural disasters of 2016, 2017, 2018, and the hail and tornadoes of 2019, have increased the number of claims that could be subject to the new rules of engagement.

In summary, over time, some of the financially stable carriers that had successfully concluded operations and navigated challenges as recently as 2015, have faced four years of storms, 2016 through 2019, that cost them at least one retention annually, been subjected to a substantial increase in reinsurance costs, utilized borrowings to replenish surplus, and while doing so found that the length of time associated with claim settlement had become elongated while the cost associated with closing those litigated files had increased beyond their estimation, and all the while, had to contend with a series of judicial decisions that revised the previously established rules of engagement regarding the settlement of claims, AND, they did so in an operating environment where they often competed with an 'insurer of last resort' whose premium structure was often lower than their own premium structure; i.e., Citizens had a cheaper premium.

What Might Mitigate the Impact of Downgrades on Consumers, Carriers and Citizens

Our most recent review of financial information, i.e., the September 30, 2019 quarterly financial statements of carriers in conjunction with our quarterly conversations with company contacts throughout 2019 and prior periods, has resulted in a request for projections of year-end 2019 operating results from nearly one-half of the 40 plus carriers that we review and rate.

Having provided these carriers with ample time to implement revised business models, secure capital infusions, implement rate revisions, re-underwrite established books of business, and utilize other enterprise risk management activities, it is apparent that few have returned to profitability. Concurrently, it is apparent to us that a large number of the companies we review, perhaps as many as 18 out of the 40 plus that we review, will not produce a level of pre-tax profitability consistent with sustaining an FSR at the A level nor position themselves to do so in the near term.

A variety of possible solutions, not one which are safe harbors, would appear to be necessary. I believe that the more obvious solutions include, but are not limited to:

- Submission to OIR of a well-documented and thorough filing to “true up” their reinsurance costs.
- A marked and immediate decrease in the interest rate applicable to the accumulated debt in their holding company
- Securing actuarially sound rates at the earliest possible date
- Access to sufficient capital to move loss and loss adjustment expense reserves to an adequate level. Our definition of adequate being ‘current period loss and LAE reserves are at a level that runs off favorably or neutral BUT not adversely.’

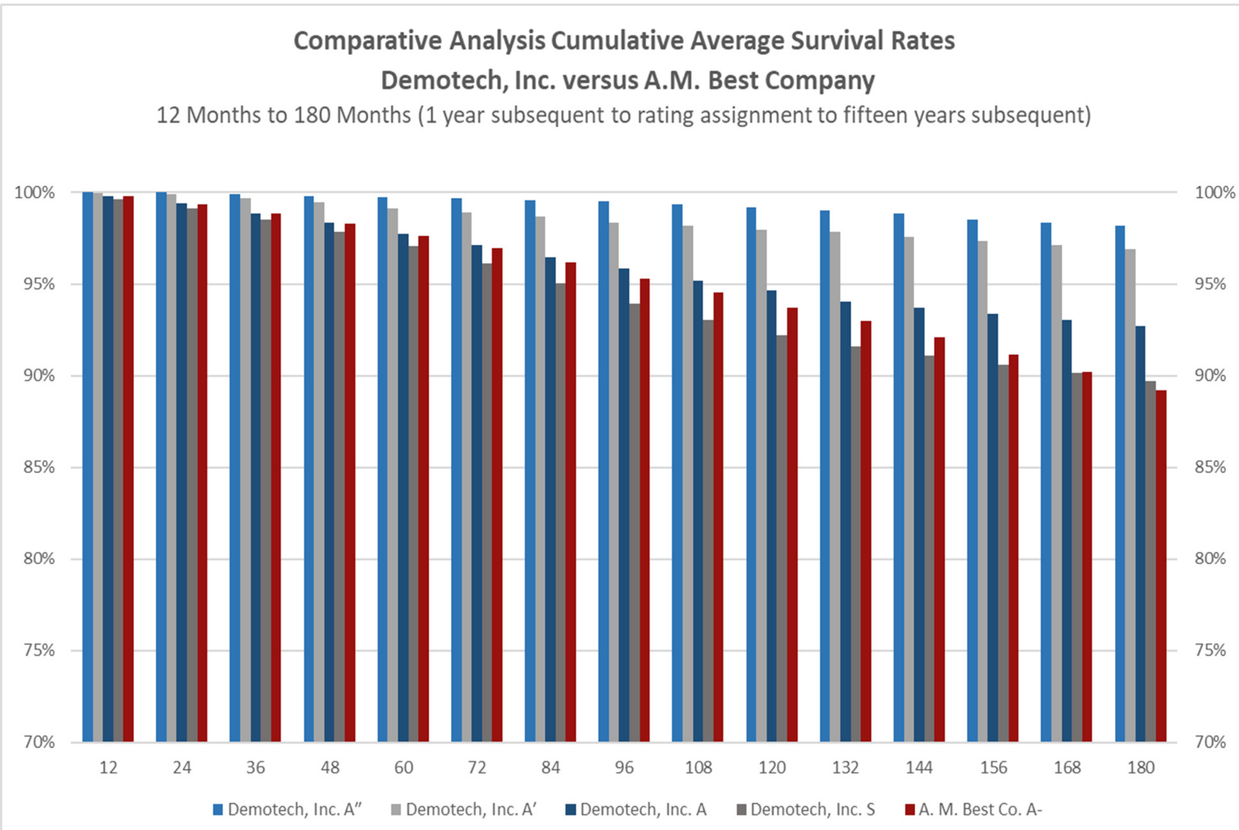
Recognizing that these solutions will take time to implement, and having provided carriers with years of notification of their issues, equity, fairness and the integrity of our rating process require that we move quickly to discern between A level carriers and carriers below the A level. As such, I discuss the status of our FSR of S, Substantial, a rating level that has been acceptable in some of the insurance sector since 1994.

In the early fall of 2012, I contacted Fannie Mae – Single Family and Freddie Mac – Single Family to request that they revise their insurer hazard insurance rating requirement for Demotech from an FSR of A to an FSR of S. I meet with representatives of the government sponsored enterprises – in separate meetings at their respective locations – soon thereafter. I have periodically submitted additional, objective, third party evidence to support our position. I even retained the services of a retired employee of Fannie, Freddie and Ginnie Mae to assist me navigate the process.

As it has been explained to me, the matter is under consideration. I have been told that the receivership of Fannie and Freddie is a bit of a complication. Jay Neal, currently Chairman, Federal Association for Insurance Reform, has also had at least one meeting with decision makers.

It has been a while since I had a substantive conversation or meeting with representatives of Fannie or Freddie; however, my last understanding of the situation was that Jonathan Breeding, Freddie mac, had been tasked with completing a review of Demotech's request, and Fannie Mae had indicated that they would follow his lead. His contact information follows this communication.

Given that the survival rates of carriers earning an FSR of S are all but comparable to the survival rates of carriers rated A- by A. M. Best, and A- by A. M. Best, is a common rating threshold in the insurance industry, the carriers we rate S present approximately the same exposure of carriers rated A- by A. M. Best. This comparison and independent studies completed by The Florida State University as well as a study by Professors Michael Barth and Robert Klein, and other information have been forwarded to representatives at Fannie and Freddie, including Jonathan Breeding.



A.M. Best Co. - Impairment Rate and Rating Transition Study, October 31, 2017. Data excludes carriers not assigned a rating due to insufficient size and/or operating experience. Ratings issued through 2016.

Demotech, Inc. - Report on Calculation and Validation of Insurer Impairment Rates for Demotech, Inc. Company status evaluated as of December 31, 2016 for ratings issued through 2016. Data includes many carriers excluded by A.M. Best.

Since 1994, Demotech FSRs of S or better have been accepted by (at least) Fannie Mae to qualify a title underwriter as acceptable security. Several insurance agent's errors and omissions insurers will accept an FSR of S or better from Demotech, including four carriers within the Munich Re family, which is the largest reinsurer in the world.

If the analysis is nearing completion and we receive notification of Fannie Mae and Freddie Mac acceptance of FSRs of S or better in the next few weeks, we should be able to avoid many of the challenges associated with downgrades IF AND ONLY IF the referenced change in acceptable ratings is effected on a countrywide basis. I say this because if the change in rating acceptability is Florida specific, the carve-out for Florida will be viewed with the same skepticism as downgrades without the change in acceptability. Whereas, countrywide acceptance will be viewed as an acknowledgement of the financial integrity of carriers earning an FSR of S.

Recognizing that time is of the essence for all stakeholders, in early January, we will confirm to carriers what they have been hearing and seeing in our quarterly communications over the past several periods – they are not executing their business model at a level that supports an FSR of A.

As Demotech views the overall insurance marketplace and the current status of the situation in Florida, there is little reason to await year-end 2019 financial statements on some of the companies. We expect to downgrade two to 4 prior by mid-January, 2020, and another 10 to 15 will face a likely downgrade once we have reviewed year-end 2019 data in March.

My hope is for a Christmas Miracle to end 2019. Specifically, a favorable conclusion to Mr. Breeding's analysis of our previously submitted request, and, with that, the ability to have a soft landing for numerous carriers, millions of Floridians, and other stakeholders in the Sunshine State's residential property insurance marketplace.

Very truly yours,

Joseph L. Petrelli

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