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Downgrades, Discussions, and Decisions

Columbus, Ohio, January 13, 2020: Demotech began involvement with the Florida homeowners' insurance market at the State's invitation in 1996 and today reviews and rates 46 insurers that write approximately 66% of Florida's homeowners' insurance premium. While Demotech reviews and rates 403 entities countrywide, the Florida-focused insurers face a variety of macro-economic and unique state specific issues. These carriers must be positioned to address these issues, or have already addressed them, to sustain the Financial Stability Ratings® (FSRs) assigned to them. The major issues are discussed below.

The major reasons for Florida downgrades have been discussed, if applicable, with carriers

Despite the potential for long-term favorable results from 2019's legislation, the cumulative impact of the economics of the marketplace over the past several years has made it difficult for each of the carriers that Demotech reviews to sustain an FSR of A, *Exceptional*, in the near term. As we see the situation, some of the major market forces and carrier financial metrics include the following:

- Insurer investor capital appears to be exiting, not entering, Florida.
- Current holding company debt, infused to support growth, strengthen loss and loss adjustment expense reserves without diminution of surplus, or support the implementation of business models, is at burdensome levels, particularly given operating losses. Often, the dollar amount of debt is burdensome, as is the interest rate on the debt.
- Carriers have paid or are negotiating their losses from the natural disasters of 2016 through 2019.
- In 2019, the change in the cost of catastrophe reinsurance was, and likely will be in the future, a financial shock to carriers. The impact of the cost of reinsurance protection impacts the net dollars that carriers can retain.
- Although carriers can "true up" reinsurance costs by making filings with the State of Florida Office of Insurance Regulation, the impact of higher reinsurance costs is immediate while the financial impact of the premium increase from "true up" takes time to be realized.
- The cumulative impact of rate revisions over the past several years is a factor. Example: an insurer that accepts a 14.9% rate increase four years in a row, when it needed a 20.0% rate increase in each of the four years, will have secured a compound rate increase of 176%. However, at 20.0%, it would have had a compound rate increase of 207%. At the end of four years, its rates would be below where they should be.



- The pricing structure of Citizens Property Insurance Corporation is too competitive for a “market of last resort.” This phenomenon may have suppressed the rate level requests of private carriers.
- Demotech requires carriers to book adequate loss and loss adjustment expense reserves. When an operating environment is characterized by stability of claims procedures, protocols, practices, and judicial decisions that uphold this claim settlement paradigm, this is a realizable objective and attainable metric. However, AOB and numerous other decisions revised the claim settlement landscape. Over time, insurers and the actuaries they depend upon were set on their heels. Each company’s own financial statement indicates the efficacy of their response to the revised landscape. Over the past several years as storms struck Florida, the revised rules of engagement on claims settlement had undue impact.

Decisions – by carriers and by Demotech

Carriers that have managed to generate realizable operating income over the recent past are stable. Others with access to sufficient unencumbered cash have the ability to withstand the financial traumas discussed above. These carriers have the financial capacity to continue to execute their business models. Based upon our communications with these insurers, our reviews of their year-end 2019 operating results are likely to result in affirmation of the FSRs currently assigned.

The carriers that borrowed money in a holding company to infuse may need to restructure debt or negotiate a lower interest rate to enable them to have the capacity to reinvigorate their business model. Their ability to demonstrate to us that they have the financial capacity to implement their business model is dependent on the level of debt and interest rate on the debt in addition to the market conditions and challenges that their competitors face. In the short run, our review of year-end 2019 operating results and our conversations with management will also require an in-depth analysis of the leverage created by debt and debt service.

Some carriers may decide to sell operations to a third party rather than recapitalize the carrier at year-end 2019. In most cases, if the final terms of acquisition are consistent with the preliminary terms provided to us, we expect to finalize the FSRs of acquiring carriers at their current level and assign a comparable FSR to the carriers that were acquired.

A number of carriers are unable to pursue their business model, cannot or will not attract capital, cannot or will not add debt, or have been unable or unwilling to find a suitor. These carriers may ask the State of Florida to permit them to voluntarily runoff outstanding claims. Policies with an unexpired term may or may not be sold to a third party. These carriers will be downgraded.

In summary, we continuously review the 403 insurers that we rate countrywide, including the 46 focused on Florida property insurance. As such, Demotech has requested and received preliminary operating results and anticipated balance sheets for year-end 2019 and may not wait for final year-end 2019 financial statements to take action. This week, we will begin to issue statements on many of the 46 Florida-focused carriers. The majority of the carriers will likely be affirmed. However,



to avoid downgrades, some carriers may abandon the necessary refinements to their business models and sell their entities or be acquired. Others will be downgraded.

Some of the Florida focused carriers we currently review and rate have the capability to emulate the success of ASI. ASI, an insurer we reviewed and rated at an FSR of A, *Exceptional*, from its inception, was initially capitalized with \$10 million. In the recent past, Progressive purchased them for approximately \$1 billion.

As the beneficial, long term impact of the legislative effort known as HB 7605 manifests itself in the operating results reported by carriers writing business in Florida, all stakeholders will benefit. However, in the near term, Demotech anticipates the need to downgrade several carriers. Those assigned an FSR of S, *Substantial*, are good carriers with the potential to return to A, *Exceptional*, if they adapt to the challenging market conditions. We are hopeful that the marketplace will embrace them during that transition.