

AIS RISK CONSULTANTS, INC.

Consulting Actuaries • Insurance Advisors

4400 Route 9 South • Suite 1200 • Freehold, NJ 07728 • (732) 780-0330 • Fax (732) 780-2706

Date: June 20, 2005

To: Steve Burgess

From: Allan I. Schwartz

Re: Preliminary Review of Cincinnati Insurance Company Florida Homeowners Rate Filing
Company File Number: (D)H-05-9103-FL, OIR File Number: FCP 05-03786

There are three main concerns with regard to the above captioned filing by Cincinnati Insurance Company (CIC). Those are the: (i) provision for catastrophe losses & ALAE, (ii) private reinsurance cost and (iii) Florida Hurricane Catastrophe Fund (FHCF) reinsurance cost. There are also some other issues that we are reviewing which have a smaller numerical impact on the rate change. These issues are discussed in more detail below.

Provision for Catastrophe Losses & ALAE

The filing shows separate loss & ALAE costs for non – catastrophes, non – hurricane catastrophes and hurricane catastrophes. The distribution of costs included in the rate level indication is as follows.

<u>Loss & ALAE Cost Component</u>	<u>Percent of Costs in Rate Filing</u>
Non – catastrophes	43.4%
Non – hurricane catastrophes	5.5%
Hurricane catastrophes	51.1%
Total	100.0%

Obviously, the rate indication filed by CIC is driven in large part by the provision for catastrophe losses, especially hurricane catastrophes. However, the filing did not provide support for the provision for catastrophes that was included. CIC appears to have relied upon the distribution of losses & ALAE filed by Insurance Services Office (ISO) on a statewide basis to derive a provision for catastrophe costs. However there are numerous problems with the approach used by CIC.

Among the concerns with the method used by CIC is that: (i) the CIC and ISO distribution of business may not be the same which can result in a different split of losses between non – catastrophes and catastrophes, (ii) the CIC and ISO definition of catastrophes may be different which can result in some costs being double counted and (iii) the CIC and ISO exposure to non – catastrophes loss & ALAE may be dissimilar which can result in the relative proportion of these costs being different.

In summary, CIC has not supported the provision for catastrophes costs included in the filing, and the method used by CIC to include catastrophes costs has several significant problems which renders it unreliable.

Private Reinsurance Cost

The CIC rate filing includes a provision for private (non – FHCF) reinsurance of 10.1% of premium. Without this private reinsurance cost provision, the indicated rate change for policy types HO-2, HO-3 and HO-5 combined would be +25.5% instead of the +40.8% included in the filing.¹

The private reinsurance cost provision included in the CIC filing is based upon numerous underlying factors including: (i) a provision for expenses, (ii) the countrywide treaty rate, (iii) the percent of costs allocated to Florida and (iv) the percent of earned premium allocated to Florida. However, CIC has not provided adequate support for any of these factors that are used to calculate the cost of private reinsurance included in the rate filing.

CIC allocated 31.5% of the catastrophe reinsurance cost to Florida, even though Florida constitutes only 3.01% of CIC's premium. That is, CIC allocates more than ten times as much cost to Florida as premium.² Furthermore, this relative relationship of reinsurance cost to premium used in the filing seems at odds with the statement made by CIC that, "Our biggest [catastrophe] exposure for our entire company is the earthquake exposure."

Another issue with regard to reinsurance is the proportion of private versus FHCF reinsurance. FHCF reinsurance is expected to be less expensive than private reinsurance. Therefore, it would make sense to obtain as much FHCF reinsurance as possible to minimize the overall cost of reinsurance and the insurance premium that would be charged to policyholders. However, CIC selects the 45% option for FHCF reinsurance instead of the 90% option. This can be expected to increase the overall cost of reinsurance, as well as the rate charged to insureds.

¹ CIC requested a rate change for these policy types of 37.5%.

² $31.5\% / 3.01\% = 10.5\%$

In summary, CIC has not supported the provision for private reinsurance costs included in the filing. In addition, the cost of private reinsurance for CIC is most likely inflated because of it has chosen to obtain a lower level of coverage from the FHCF.

FHCF Reinsurance Cost

The CIC rate filing includes a provision for FHCF reinsurance of 10.9% of premium. Without this FHCF reinsurance and private reinsurance cost provisions, the indicated rate change for policy types HO-2, HO-3 and HO-5 combined would be +14.1% instead of the +40.8% included in the filing.

An allowable reinsurance cost in the rate filing is the reasonable net cost of reinsurance. The net cost of reinsurance is equal to premiums less expected recoveries. Given the large value for FHCF reinsurance included in the filing, it does not appear that CIC used a net cost of reinsurance, but instead just used premiums without consideration of expected recoveries. Because of this, the FHCF reinsurance cost included in the filing is inflated and results in an excessive rate level indication.

In summary, CIC has not supported the provision for FHCF reinsurance costs included in the filing, and the provision included in the filing is inflated and results in an excessive rate level indication.

Other Issues

Premiums for homeowners insurance increase over time because the amount of insurance exposure base used is inflation sensitive. As the amount of insurance for the house increases, the premium charged by the insurance company increases. In determining an appropriate rate level, the additional revenue generated by increases in the amount of insurance needs to be taken into account. CIC uses an inflation guard factor of 2% per quarter (not compounded) to increase the amount of insurance over time. However, the CIC rate filing uses a premium trend factor to account for increases in the amount of insurance of only 3.2% per year. Given the inflation guard factor of 2% a quarter, it would seem that the premium trend should be more than 3.2% a year. A higher premium trend would result in a lower rate level indication.

Insurance companies obtain revenue not just from the premiums paid by policyholders, but also from investing those funds. In determining an appropriate rate level, the amount of revenue insurance companies earn from investments needs to be taken into account. The more money an insurance company can earn from investments, the less that needs to be collected from policyholders as premiums. In its filing, CIC assumes that it can earn only a 3.35% investment return, and that the investment income earned will be only 0.42% of premium. Both of these values seem very low. During 2004 CIC had average invested assets of about \$7.45 billion and an investment gain of \$469 million, which is an investment return of 6.3%. According to the National Association of Insurance Commissioners (NAIC), the investment gain for Florida homeowners insurance in relation to premium during 2003 was 3.0%.³ Using a higher value for investment income would result in a lower rate level.

Please feel free to contact me if there is anything you would care to discuss.

³ NAIC report on profitability by line by state for 2003