Consumer Federation of America

October 4, 2004

The Honorable Tom Gallagher
Chief Financial Officer
Florida Department of Financial Services
State Capitol
Plaza Level Eleven
Tallahassee, FL 32399

Re: Preventing Unjustified Rate Increases by Insurers in Wake of Recent Hurricanes

Dear Chief Financial Officer:

In the wake of the multiple hurricanes of 2004, consumers have been calling us to ask what impact on their rates they might see in the months ahead. I have told them that I think that these rate impacts should be minor. I am writing to you to ask what you are doing to assure that rates do not rise unnecessarily.

I believe that the rate impacts of this season should not be great. The most important reason for this is that, in the last ten years, insurers have instituted hurricane modeling to determine hurricane risk factors and rates. Prior to Hurricane Andrew, insurers typically set hurricane prices based on 20 to 40 years of historic experience. Based on the relatively low rates that resulted from this inadequate method, major insurers aggressively wrote homeowners insurance all over Florida, even on barrier islands.

Short-term history proved insufficient for ratemaking when Hurricane Andrew struck. Insurers were shocked at the severity of the damage. This led them to limit writings and to move to restrict coverage in several ways (percentage deductibles, caps on replacement cost, limits on code upgrade coverage, etc.).

It also sent them back to the drawing board to create new ratemaking methods. They chose scientific modeling as the method to set prices after Andrew. Several different modelers emerged. They all used the best information available to model hurricanes so that they could “create” virtual hurricanes that would come ashore in different places with different wind, tidal and other factors. Using the best experts and all available historic hurricane data, these models generated thousands of years of virtual experience so that rates could be set using the best science. Data on the impact of these virtual hurricanes was matched with the portfolios of homes insured by each insurer using the model so that resulting rates would reflect the actual geographic distribution of risk of the specific insurer.

One season of hurricanes should not significantly alter the science underlying these models. In low frequency/high severity ratemaking, it is easier to estimate the severity underlying rates than the frequency underlying rates. Interestingly, some of the modelers appear to have estimated damages from this year's storms to be somewhat higher than what actually resulted. An example of this development is that Hurricane Charley was estimated to produce $16 billion in losses shortly after crossing Florida; more than twice the current estimates.

If estimated severity is in fact on the high side in these models, that might indicate a minor reduction in rates is needed, everything else being equal. In order to make this determination, I strongly urge you to require the modelers to demonstrate the damage estimates to you that these four hurricanes would predict if run through their models using the same parameters as underlying current rates. You can then compare this data to information you have about actual damage to see if there is some upward bias in the models.

As to frequency considerations, four hurricanes in a season might make one question whether these models have underestimated the frequency of these events. I don't know if this is true or not. To find out, I urge you to require the modelers to query their models to see how many seasons out of their thousands of virtual seasons the models predict four Florida hurricanes such as those Florida experienced in 2004. Four hurricanes may in fact be already adequately incorporated in the models. One year of frequency data should not significantly alter the true underlying frequency of storms.

In order to prevent opportunistic and unjustified rate increases by insurers, it is vital that you seek information such as I have recommended before insurers submit rate requests.

Sincerely,

J. Robert Hunter
Director of Insurance

CC: Senator Bill Nelson
Senator Bob Graham