Consumer Federation of America
CENTER FOR ECONOMIC JUSTICE

March 27, 2006

The Honorable Alessandro Iuppa
NAIC President, Superintendent,
Maine Bureau of Insurance
State Office Building, Station 34
Augusta, Maine 04333

Dear Superintendent Iuppa:

We write to urge you to reject dramatic changes proposed last week by Risk Management Solutions (RMS) to its hurricane modeling methods that will lead to unjustified increases in homeowners and other property/ casualty insurance rates and to begin a public examination of these proposed changes. We also urge you to immediately take steps to increase regulation of third-party organizations whose work has such a significant impact on insurance rates and availability.

On March 23, 2006, Risk Management Solutions (RMS) announced that it was changing its hurricane model upon which homeowners and other property/ casualty insurance rates are based. RMS said that "increases to hurricane landfall frequencies in the company's U.S. hurricane model will increase modeled annualized insurance losses by 40% on average across the Gulf Coast, Florida and the Southeast, and by 25-30% in the Mid-Atlantic and Northeast coastal regions, relative to those derived using long-term 1900-2005 historical average hurricane frequencies." This means that the hurricane component of insurance rates will sharply rise, resulting in overall double digit rate increases along America's coastline from Maine to Texas.

One might ask, given the fact that RMS initially developed its model in the wake of Hurricane Andrew, why its prior projections were so far off the mark? Did insurers and modelers not know what they were doing then? Do they not know what they are doing now? If we assume the best -- that the insurers and modelers were incompetent -- there is clearly a need for regulatory oversight to improve the quality of the decision-making. If we assume the worst -- that the changes are driven by politics and not science -- the same need for regulatory oversight exists.

While RMS claims that this massive increase is necessary for scientific reasons, the evidence indicates that the primary reason for the change appears to be not science at all, but politics. This is because RMS has dramatically altered the methodology that is being used to predict wind events and set consumer rates, breaking promises that were made to consumers over a decade ago when more sophisticated weather modeling was introduced.

RMS is now projecting wind events for just five years at a time during a period of cyclically high hurricane activity. In its press release of March 23, 2006, RMS justified the major change in course as follows:

> To address this period of elevated frequency and intensity of storms, RMS consulted with representatives from all segments of the insurance industry and updated its U.S. and Caribbean hurricane models to provide a 'medium-term' (five-year) forward-looking view of risk for estimating potential catastrophe losses. To date, catastrophe model results have been based on a long-term historical average baseline.

This approach is the complete opposite of that promised by insurers when these models were introduced. Consumers were told that, after the big price increases in the wake of Hurricane Andrew, they would see price stability. This was because the projections were not based on short-term weather history, as they had been in the past, but on very long-term data from 10,000 to 100,000 years of projected experience. The rate requests at the time were based upon the average of these long-range projections. Decades with no hurricane activity were assessed in the projections as were decades of severe hurricane activity, as most weather experts agree we are experiencing now. Small storms predominated, but there were projections of huge, category 5 hurricanes hitting Miami or New York as well, causing hundreds of billions of dollars in damage. Consumers were assured that, although hurricane activity was cyclical, they would not see significant price decreases during periods of little or no hurricane activity, nor price increases during periods of frequent activity. That promise has now been broken.

RMS has become the vehicle for collusive pricing. In its report on its new hurricane model, RMS states:

> In developing the new medium-term five-year view of risk, RMS has taken counsel from representatives across the insurance industry in determining that future model output will be for a 'medium-term' five-year risk horizon.[1]
>
> <u>To determine what should be the explicit risk horizon of an RMS Cat model, opinions were solicited among the wider insurance industry</u> from those who both use and apply the results of models <u>to find the duration over which they sought to characterize risk</u>."[2](Emphasis added)

It is clear from the release that insurance companies ("the market") sought this move to higher rates. RMS's press release of March 23, 2006 states:

> 'Coming off back-to-back, extraordinarily active hurricane seasons, the market is looking for leadership. At RMS, we are taking a clear, unambiguous position that our clients should manage their risks in a manner consistent with elevated levels of hurricane activity and severity,' stated Hemant Shah, president and CEO of RMS. 'We live in a dynamic world, and there is now a critical mass of data and science that point to this being the prudent course of action.'

The "market" (the insurers) sought leadership (higher rates), so RMS was in a competitive bind. If it did not raise rates, the market would likely go to modelers who did. So RMS acted and the

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[1] Risk Management Solutions, "U.S. and Caribbean Hurricane Activity Rates," March 2006, page 1.
[2] Risk Management Solutions, "U.S. and Caribbean Hurricane Activity Rates," March 2006, page 4.

other modelers are following suit. According to the National Underwriter's Online Service (March 23, 2006): "Two other modeling vendors—Boston-based AIR Worldwide and Oakland, Calif.-based Eqecat—are also in the process of reworking their hurricane models." It is shocking and unethical that scientists at these modeling firms appear to have completely changed their minds at the same time after over a decade of using models they assured the public were scientifically sound.

Insurers often try to position supposedly objective and independent third parties as the public decision-makers when it is insurers themselves who want to increase rates. For decades, the third parties that often performed this function were ratemaking (advisory) organizations such as Insurance Services Office (ISO). At least ISO and other rating organizations were licensed by the states and subject to regulation, because of the important impact they had on rates and other insurance tools, such as policy forms. However, even ISO and other regulated advisory organizations are prohibited from collusive pricing activity that is not subject to state insurance regulation.

More recently, insurers have utilized new third party organizations to provide information (often from "black boxes" beyond state insurance department regulatory reach) for key insurance pricing and underwriting decisions, which helps insurers to avoid scrutiny for their actions. These organizations are not regulated by the state insurance departments and have a huge impact on rates and underwriting decisions with no state oversight. RMS is one such organization. Fair Isaac and ChoicePoint are also an example of third party vendors not subject to state insurance department regulation. They provide credit scoring and other data used for underwriting and rating that have a profound impact on insurance availability, affordability and pricing.

We are very concerned about two aspects of the RMS activity. First, RMS seems clearly to be engaged in collusive pricing activity, which does not appear to be protected by state insurance regulation. Regulators tasked with protecting consumers must examine and stop such behavior. Second, the computer underwriting and rating models – whether they be catastrophic models or credit scoring models – are based on critical assumptions – as opposed to "objective" science – that affect insurance availability and affordability and the nature of the insurance mechanism itself. We urge you to expose these assumption to public debate for reasonableness and consistency with basic public policy goals of insurance.

The issue with the RMS catastrophic model is part of our broader concern about the lack of meaningful oversight of risk classification procedures because these models project differential prices by territory within your states. It is long past time for state insurance regulators to recognize that risk classification methods -- the factors insurers use for underwriting, tier placement and rating -- have a profound impact on insurance availability and affordability and are not subject to competitive market forces that protect consumers.[3] State

[3] Indeed, class factors are often adopted by insurers to guard against potential adverse selection, frequently even if the insurer does not agree with the theory underlying the class system. Thus, Blue Cross/Shield was forced to abandon community rating and move to rating based upon health and age, although it thought America would be better off with a system where all insurers used community rating. Thus, State Farm reluctantly moved to use of credit scores for rating. The insurer who dreams up new, non-risk related classes, moves the entire industry toward that class.

insurance regulators generally, and the NAIC in particular, have taken no steps to increase oversight of risk classification methods, despite numerous opportunities. The NAIC has done nothing to prevent the adverse effects of insurers' increased use of credit information or improper use of loss history databases. State regulators have also generally done nothing about risk classification factors that obviously discriminate against low income consumers, including use of information about prior liability limits, education and occupation.

There are two crucial reasons for the NAIC to immediately start work on a model law and regulation regarding personal lines risk classification. First, there must be oversight of risk classification systems to ensure that the two fundamental public policy goals of insurance -- providing consumers with an essential financial security tool through risk spreading and providing economic incentives for loss prevention -- are enhanced and not undermined. Consumers are not meaningfully protected when a regulator forces an insurer to lower an overall rate change by a few percentage points when the regulator pays no attention to changes in risk classification that cause some consumers' rates to jump by a 100 percent or more. Regulators must take seriously the issue of redlining and confront the role played by risk classification proxies for race and income. Regulators must also take responsibility for failing to act as insurers used "tier rating" as an excuse to hide important risk classification changes from regulators and start examining underwriting and tier placement guidelines.

Second, the case for state-based regulation must be made, in large part, on the need for regulatory oversight of risk classification issues. Insurers recently chastised the Personal Lines Framework Working Group of the Speed to Market Task Force for considering a revised file-and-use model law. According to industry spokespeople, the Members of Congress are watching what the states are doing and if the states fail to "modernize" -- the industry's euphemism for deregulation of rates, forms and risk classification -- Congress will be forced to take action. The industry threat is illogical. If Congress truly believes that deregulation is the best approach, then who better to force deregulation on the states than the federal government? State regulators cannot make the case for state insurance regulation by gutting state regulation. Rather, the case for state-based regulation can be made by showing Congress and the public why regulatory oversight is needed for certain aspects of insurance ratemaking and why the states are in the best position to provide that type of oversight. Stated differently, perhaps the best way for the NAIC to make the case for state-based regulation is to quickly develop personal lines regulatory models that recognize those areas where "competition" fails to protect consumers -- policy forms and risk classification, for example -- and develop a coherent framework for evaluating the appropriateness of certain risk classification characteristics.

We urgently request the following actions by state insurance regulators and the NAIC:

1. State regulators should reject the new RMS wind model as the basis for any rate increase and examine how this new model was developed. It is clear that the <u>assumptions</u> underlying the model, such as the five-year horizon, need to be fully identified and reviewed in a public forum. One possibility for such a review might be for regulators in potentially-affected states to hold a joint hearing where RMS is asked to publicly explain just what it is doing and why. You should request or, if necessary, subpoena information on their contacts with the insurers in the run-up to this announcement to determine just what sort of pressure might have been brought to bear on RMS to raise rates. We also urge you to determine whether industry pressure that might have

been exerted is protected by the McCarran-Ferguson Antitrust Exemption. We are prepared to assist regulators in developing additional questions for RMS.

2. State regulators must exercise existing regulatory authority, or, if necessary, obtain additional legal authority (see next point) to regulate third party organizations whose work has a significant effect on insurance rates and availability, such as RMS and Fair Isaac. These are third party vendors whose "black-box" products are replacing traditional risk classification factors. The goal of this regulation would not be to stop innovation, but to ensure that innovative risk classification methods serve the fundamental purposes of the insurance mechanism, such as spread of risk and fairness for all, particularly for protected classes.

3. Task the Personal Lines Regulatory Framework Working Group of the Speed to Market Task Force with developing a modern personal lines regulatory framework that recognizes the differences between regulation of policy forms, risk classifications and overall rate levels. This can be accomplished this year as both the Center for Economic Justice and the Consumer Federation of America have provided detailed recommendations that could form the basis for discussion. It is clear that a modern personal lines regulatory framework must also include specific regulatory oversight of third party vendors whose products are used for risk classification and rating and must include active regulatory oversight of underwriting guidelines, whether these guidelines are tier placement rules or anything else, as well as rating factors.

CFA and CEJ look forward to working with you on this important matter.

Yours truly,

J. Robert Hunter
Director of Insurance
Consumer Federation of America

Birny Birnbaum
Executive Director
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cc: Representative Frank Wald, President, National Conference of Insurance Legislators
Insurance Commissioners in East Coast and Gulf Coast states
Attorneys General in East Coast and Gulf Coast states