



Florida Office of Insurance Regulation

REVIEW OF FLORIDA SINKHOLE INSURANCE PROPOSAL

**Calculation of Section 40
“Presumed Factor”**

Deloitte.

September 1, 2006



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September 1, 2006

Mr. Michael Milnes
Contract Manager and Deputy Director
Office of Insurance Regulation
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200 East Gaines Street, Suite 121
Tallahassee, FL 32399-0326

Dear Mr. Milnes:

We are pleased to submit our actuarial review of the impact to rates made by the provisions of Chapter Law 2006-12 (SB 1980) related to sinkhole losses and Sections 17, 18, 19, 20, and 21 of Chapter Law 2005-11, and our calculation of Section 40's "Presumed Factor".

It was a pleasure working with you and we look forward to serving the Office of Insurance Regulation in the future. Please do not hesitate to call either Jan at (860) 725-3050, Kevin at (860) 725-3056 or Rich at (305) 371-2600 if we can be of any further assistance.

Sincerely,

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PRESUMED FACTOR

TABLE OF CONTENTS

	<u>Page</u>
I. Executive Summary	1
Purpose and Scope	1
Background	2
Distribution and Use	10
Reliance and Limitations	10
Presumed Factor Findings	12
II. Presumed Factor by Section	13
Chapter Law 2005-111	
Section 17 – Sinkhole Insurance; Definitions.....	14
Section 18 – Database of Information Relating to Sinkholes	15
Section 19 – Standards for Investigation	16
Section 20 – Testing Standards for Sinkholes	19
Section 21 – Sinkhole Reports.....	19
Chapter Law 2006-12	
Section 25 – Sinkhole Insurance; Definitions.....	21
Section 26 – Standards for Investigation	22
Section 27 – Testing Standards for Sinkholes	23
Section 28 – Sinkhole Reports.....	23
Section 29 – Alternative Procedure for Resolution	25
III. Presumed Factor Summary Matrix	36
IV. Observations	37
V. Appendix	46
A. Homeowners Insurance 101	47
B. Florida County Map and “Sinkhole Alley” Counties	48
C. OIR Market Share Reports.....	51

PRESUMED FACTOR

I. EXECUTIVE SUMMARY

PURPOSE AND SCOPE

Deloitte Consulting LLP (Deloitte Consulting) has been retained by the Florida Office of Insurance Regulation (OIR) to evaluate the impact of recent legislative reforms on sinkhole insurance in Florida and recommend a presumed factor.

Section 40 of the bill states:

- (1) By September 1, 2006, the Office of Insurance Regulation shall calculate a presumed factor to reflect the impact to rates of the changes made by the provisions of this act related to insurance claims for sinkhole losses and by Sections 17, 18, 19, 20, and 21 of chapter 2005-111, Laws of Florida.
- (2) In determining the presumed factor, the OIR shall use generally accepted actuarial techniques and standards in determining the expected impact on losses, expenses, and investment income of the insurer.
- (3) The OIR may contract with an appropriate vendor to determine the presumed factor.
- (4) Each residential property insurer shall, at its next rate filing after October 1, 2006, reflect a rate change that takes into account the presumed factor determined under subsection (1).

In accordance with the contract signed on July 11, 2006, Deloitte Consulting has been asked by the OIR to analyze the provisions of Chapter Law 2006-12 (SB 1980) related to sinkhole losses and Sections 17, 18, 19, 20, and 21 of Chapter Law 2005-11 and provide a presumed factor impact, by Section, expressed in the form of a one decimal place percentage adjustment to base rates. Where a Section has no rate impact, Deloitte Consulting discloses it.

PRESUMED FACTOR

BACKGROUND

Since 1981, Florida insurers offering property coverage to homeowners have been required by law to offer coverage for damage resulting from sinkholes for:

- Covered structures
- Stabilizing the ground beneath covered structures¹

A sinkhole is defined in Florida law (Section 627.706, F.S., 2005) as a landform created by subsidence of soil, sediment, or rock as underlying strata are dissolved by ground water. A sinkhole may form by collapse into subterranean voids created by dissolution of limestone or dolostone or by subsidence as the strata are dissolved.

Sinkholes are a naturally occurring phenomenon as rain and groundwater flow through the top layer of soil into the limestone and dolomite layers that underlie most of Florida. Although sinkholes do occur naturally, sinkholes occur more frequently due to human interaction with the state's natural environment (e.g., excessive ground water pumping by farmers, construction practices, diverting surface water, etc.).

In situations where sinkhole claims are denied by insurance companies, reasons include settling, decay, compression of organic debris, soil settlement, clay shrinkage, septic tank collapse, sewer pipe damage, no damage to structure and upheaval of structure by trees. According to the Florida State University Report titled "Insurance Study of Sinkholes", the first five reasons account for 80 percent of insurance company denials. In situations where sinkhole claims are approved, remediation often requires the use of two procedures, compaction grouting, bridging/underpinning, or a combination of the two procedures.

For further background information on the history of Florida's sinkhole crisis, please refer to the April 2005 Florida State University report titled "Insurance Study of Sinkholes" prepared at the

¹ House of Representatives Staff Analysis on SB286, Summary Analysis.

PRESUMED FACTOR

request of the 2004 Florida Legislature. This report can be downloaded at http://www.floir.com/LegislativeAffairs/2005_reports_studies.htm.

“Sinkhole Alley” Counties

Although the new sinkhole legislation applies to the state as a whole, the majority of sinkhole related claims are generated in Pasco, Hernando, Pinellas, and Hillsborough counties near Tampa, often referred to as “Sinkhole Alley”.² As is noted in the House of Representatives Staff Analysis.

As will be discussed below in Section 29; if the insurer agrees in writing with the neutral evaluator’s assessment and timely complies with the recommendations, the insurer is no longer liable for extra-contractual damages related to the sinkhole loss with respect to the issues determined by the neutral evaluation process. However, we note that it is the position of Citizens that it is exempt from bad faith liability due to the language of section 627.351(6)(i), which is part of its enabling statute. If Citizens is, in fact, exempted from bad faith liability under its enabling statute, then the changes to Section 29 eliminating bad faith liabilities under certain circumstances would have no impact on Citizens. Given the number of policies that have moved from other insurance companies to Citizens, the savings to insurance companies from this change would likely be minimal. Unfortunately, we were unable to obtain credible information on the percentage of sinkhole claim payments resulting from bad faith allegations made by policyholders. The counties in the west central portion of the state are particularly prone to sinkhole formation and collapse because the limestone in that area is closer to the surface, thus making the rock layer beneath the surface more vulnerable to erosion.

In the data provided to Deloitte Consulting by Citizens Property Insurance Corporation (Citizens), 95 percent of all sinkhole claims and 98 percent of all sinkhole loss and loss

² Please refer to Appendix B for Florida county map and expanded maps of Pasco, Hernando, Pinellas and Hillsborough counties. Please refer to Appendix C for insurance company market share information.

PRESUMED FACTOR

adjustment expense (LAE) dollars, from January 1, 2004 through July 31, 2006, have been reported in these four counties.^{3,4}

Citizens' sinkhole loss experience has deteriorated from 9 claims reported in 2002 for just under \$300,000 to 632 claims reported in 2005 for \$86.2 million. Through July 31, 2006, there have been 432 claims reported totaling \$73.5 million in reported loss and LAE. Extrapolating those amounts out to year end 2006, we estimate that Citizens would handle around 740 claims amounting to approximately \$125 million in loss and LAE payments.

Tables 1a and 1b show the percentage of claims reported by county in Sinkhole Alley and the rest of Florida in total for all claims reported to Citizens between January 1, 2004 and July 31, 2006.

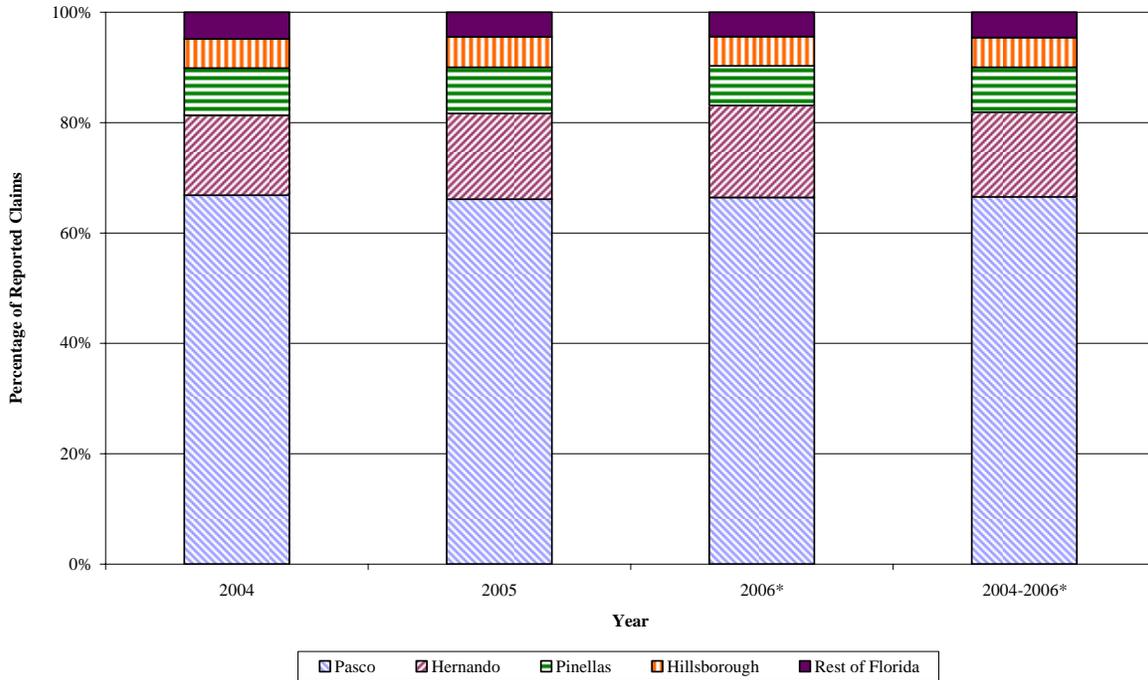
³ Loss adjustment expenses include defense and cost containment (DCC) and adjusting and other (AO). DCC represents expenses such as surveillance expenses, fixed amounts for medical cost containment, litigation management expenses, attorney fees incurred owing to a duty to defend, and fees/salaries for appraisers, investigators, working on the defense of a claim. AO represent expenses such as fees and expenses of adjusters and settling agents, fees/salaries for appraisers, investigators, if working in the capacity of an adjuster, and attorney fees incurred in the determination of coverage, including litigation between an insurer and the policyholder. The insurance industry changed its terminology in the late 90's from allocated loss adjustment expense (ALAE) to DCC and unallocated loss adjustment expense (ULAE) to AO, noting that the relationship was not one-to-one.

⁴ The company only provided aggregated data (i.e., no claim level detail was provided).

PRESUMED FACTOR

Percentage of Reported Sinkhole Claims by County
Citizens data through 7/31/2006

Table 1a



Citizens' Reported Sinkhole Claims for "Sinkhole Alley"
Through 7/31/2006

Table 1b

<u>County</u>	<u>2004</u>	<u>%</u>	<u>2005</u>	<u>%</u>	<u>2006*</u>	<u>%</u>	<u>2004 -</u>	<u>2006*</u>	<u>%</u>
Pasco	541	66.9%	418	66.1%	287	66.4%	1,246	66.5%	
Hernando	117	14.5%	98	15.5%	72	16.7%	287	15.3%	
Pinellas	69	8.5%	53	8.4%	31	7.2%	153	8.2%	
Hillsborough	43	5.3%	35	5.5%	23	5.3%	101	5.4%	
"Sinkhole Alley"	770	95.2%	604	95.6%	413	95.6%	1,787	95.4%	
Rest of Florida	39	4.8%	28	4.4%	19	4.4%	86	4.6%	
State Total	809	100.0%	632	100.0%	432	100.0%	1,873	100.0%	

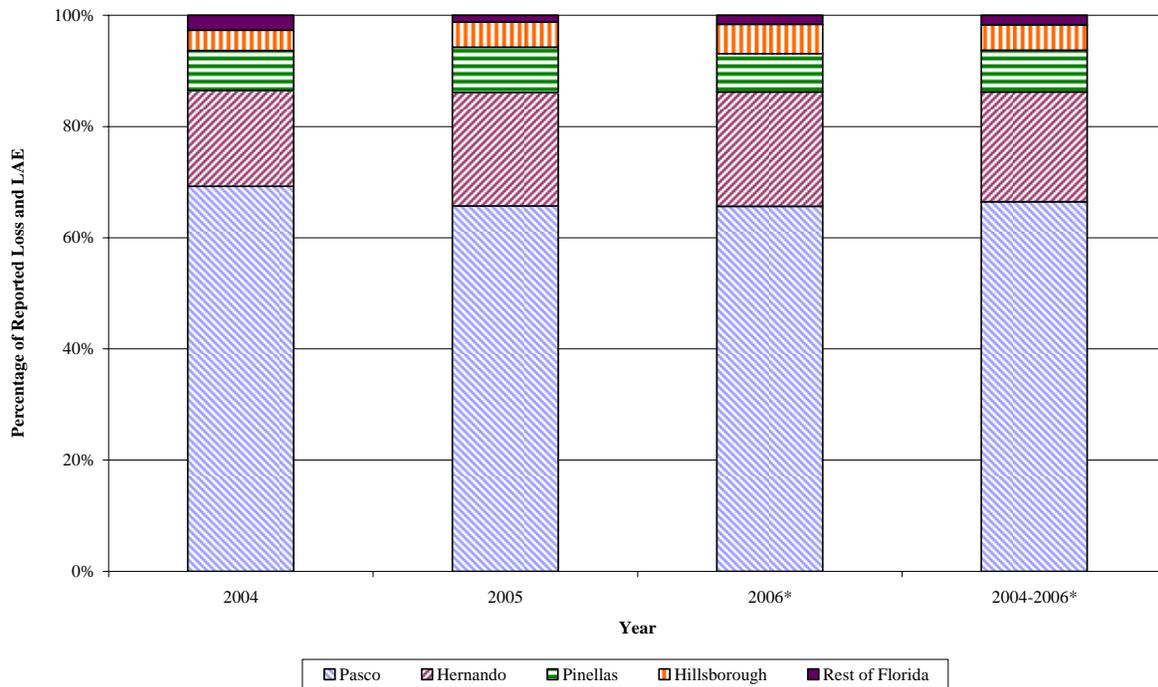
*Through 7 months of 2006

PRESUMED FACTOR

Tables 2a and 2b show the percentage of loss and LAE reported by county in Sinkhole Alley and the rest of Florida in total for all claims reported to Citizens between January 1, 2004 and July 31, 2006.

Percentage of Reported Sinkhole Loss and LAE by County
Citizens data through 7/31/2006

Table 2a



Citizens' Reported Sinkhole Loss and ALAE for "Sinkhole Alley"
Through 7/31/2006
(in Thousands)

Table 2b

County	2004	%	2005	%	2006*	%	2004 - 2006*	%
Pasco	31,827	69.3%	56,636	65.7%	48,243	65.6%	136,706	66.5%
Hernando	7,907	17.2%	17,597	20.4%	15,137	20.6%	40,641	19.8%
Pinellas	3,313	7.2%	7,043	8.2%	5,042	6.9%	15,398	7.5%
Hillsborough	1,667	3.6%	3,881	4.5%	3,896	5.3%	9,444	4.6%
"Sinkhole Alley"	44,713	97.3%	85,157	98.8%	72,318	98.4%	202,188	98.3%
Rest of Florida	1,239	2.7%	1,047	1.2%	1,193	1.6%	3,479	1.7%
State Total	45,952	100.0%	86,204	100.0%	73,511	100.0%	205,667	100.0%

PRESUMED FACTOR

Table 3 shows the growth of the average reported loss and LAE per sinkhole claim reported to Citizens since 2004 through July 31, 2006.

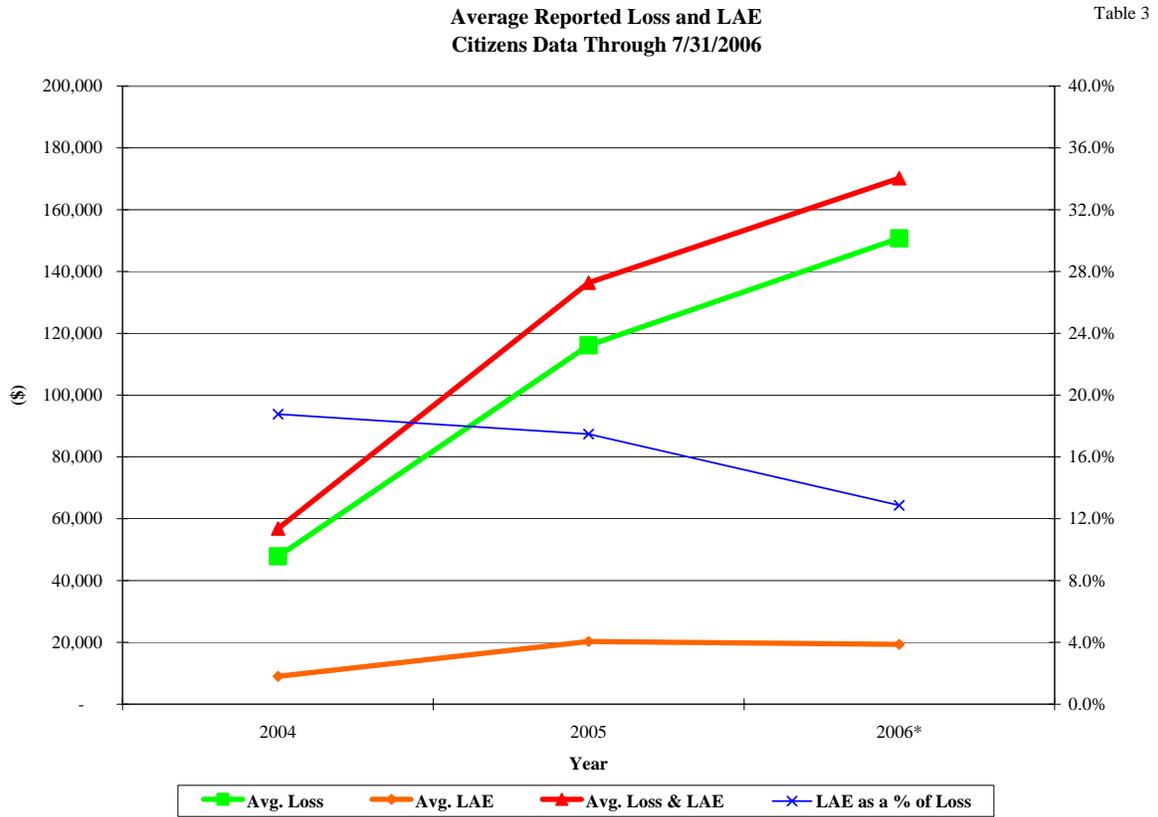


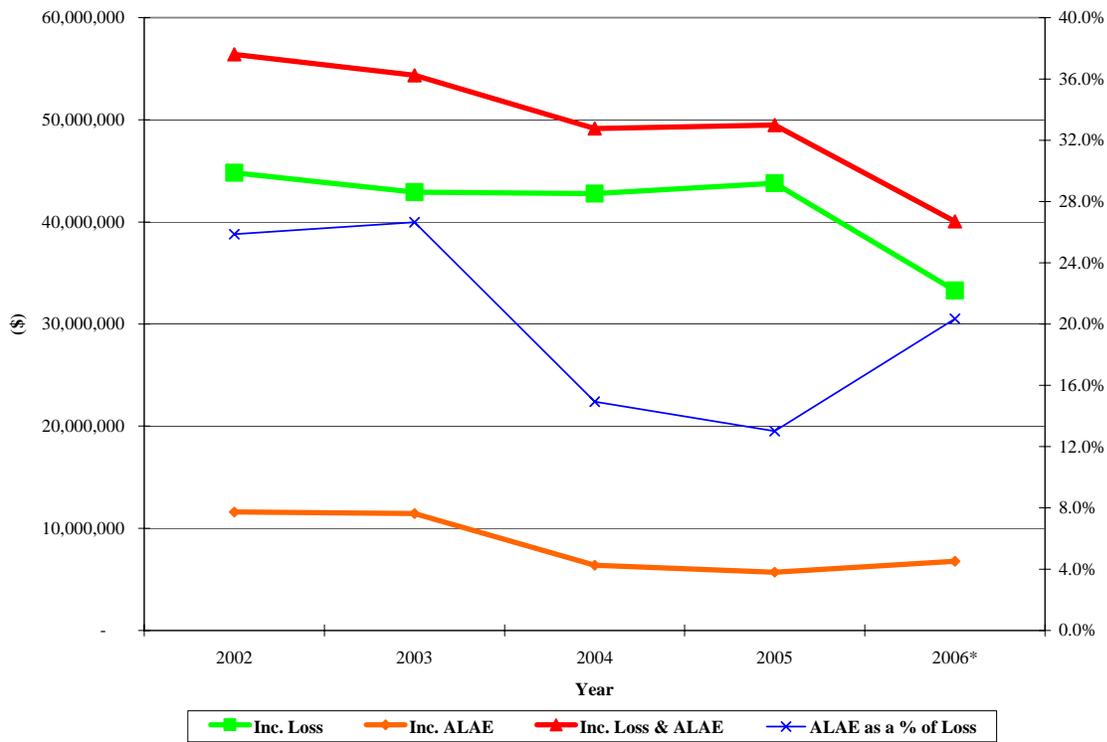
Table 4 shows State Farm’s incurred loss and allocated loss adjustment expense (ALAE) sinkhole data through June 30, 2006 for years 2002 through 2006.⁵

⁵ The company only provided aggregated data (i.e., no claim level detail was provided).

PRESUMED FACTOR

**Incurred Reported Loss and ALAE
State Farm Data Through 6/30/2006**

Table 4



* - Data for 2006 has been annualized to a full year for illustration purposes

Through June 30, 2006, there has been \$16.6 million in reported losses and \$3.3 million in ALAE. Extrapolating those amounts out to year end 2006, we estimate that State Farm would handle claims amounting to approximately \$40 million in loss and ALAE payments.

In addition, we have reviewed the State Farm data contained in the St. Petersburg Times article published by Garrett Therolf on May 29, 2006 titled “Sinkhole Payouts Creating a Crisis?” This data shows that State Farm is experiencing a sharp upward trend in sinkhole loss payments similar to Citizens in “sinkhole alley”. State Farm sinkhole claims increased from just 6 claims in 1994 to in excess of 400 claims in 2002, 2003 and 2004. State Farm paid out an estimated \$52 million in sinkhole claims in 2005. Although State Farm’s sinkhole loss payments appear to have stabilized around the \$50 million level since 2002, we are unable to determine from the

PRESUMED FACTOR

article whether the stabilization is driven by reduced exposure as State Farm non-renews policies. State Farm and other insurance companies have non-renewed policies in these counties over the past few years, which is a contributing factor in the dramatic increase in Citizens' sinkhole claim activity.

Citizens filed a rate change⁶ effective 11/1/2004 for new business (1/1/2005 for renewal business) aimed at adjusting HO-3 rates in sinkhole prone territories to meet the actuarially justified costs. The following adjustments were made:

<u>Territory</u>	<u>County</u>	<u>% Change</u>
736	Pasco, Remainder	73.5%
595	Pasco, Coastal	55.7%
733	Hernando, Remainder	52.6%
159	Hernando, Coastal	38.6%
692	Lake	33.1%
731	Citrus, Remainder	27.3%
	Other sinkhole counties ⁷	5.0%
	Florida Total	3.7%

Citizens also added in this filing an underwriting rule declaring any property sustaining damage and receiving payment for a sinkhole loss as uninsurable, unless the insured can certify that the recommended repairs or other approved stabilization repairs were completed.

⁶ FL OIR filing reference number 04-09416 is available from the Office of Insurance Regulation I-File Workflow System Forms & Rates Search Page web site (<http://www.fldfs.com/edms>).

⁷ Other sinkhole counties include: 591 Citrus, Coastal, 047 Hillsborough, Tampa, 080 Hillsborough, Excl. Tampa, 792 Marion, 049 Orange, Orlando, 090 Orange, Excl. Orlando, 042 Pinellas, Coastal, 046 Pinellas, St. Petersburg, 081 Pinellas, Remainder, 050 Polk, and 512 Seminole.

PRESUMED FACTOR

State Farm's rate filing⁸ effective 1/1/2006 for new business (3/1/2006 for renewal business) displayed non-catastrophe paid sinkhole losses divided by earned premium by territory for 2000 through 2004. Below are the territories with sinkhole losses representing greater than 20 percent of the premium earned:

Sinkhole Loss to Earned		
<u>Territory</u>	<u>County</u>	<u>Premium Ratio</u>
25	Pasco, Coastal	137%
22	Hernando, Coastal	81%
23	Hernando, Remainder	67%
26	Pasco, Remainder	52%
43	Citrus, Coastal	24%
46	Hillsborough, Excl. Tampa	23%
15	Pinellas, Excl. St. Petersburg	23%
44	Citrus, Remainder	22%

DISTRIBUTION AND USE

Deloitte Consulting understands that records or data produced by Deloitte Consulting in response to this engagement are subject to applicable public records law(s). OIR personnel are available to respond to any questions with respect to this report. Deloitte Consulting will direct all third party requests for such records to the OIR.

RELIANCE AND LIMITATIONS

Estimates of the presumed factor by Section are based on background information, publicly available information, phone interviews, exposure data and loss data provided by the OIR, Citizens and State Farm. A specific audit of the data and background information is beyond the

⁸ FL OIR filing reference number 05-09694 is available from the Office of Insurance Regulation I-File Workflow

PRESUMED FACTOR

scope of this project. We have conducted such reasonableness tests of the data as we felt appropriate. In all other respects, we have relied without audit or verification on the data and background information provided. Any assumptions, adjustments or modifications made by Deloitte Consulting to the data will be documented in detail throughout the remainder of this report.

In our opinion, the analysis presented herein for the OIR provides presumed factors by Section based on accepted actuarial standards and principles.

In estimating the presumed factor by Section, we have assumed that historical trends, adjusted for the impact, if any, of the provisions of Chapter Law 2006-12 (SB 1980) related to sinkhole losses and Sections 17, 18, 19, 20, and 21 of Chapter Law 2005-11, can be used to predict future losses. The estimates make no provision for extraordinary future emergence of new types of losses not sufficiently represented in the historical information we reviewed or which are not yet quantifiable. We have applied what we feel are reasonable procedures in our analysis. However, due to the volatility of the loss exposures reviewed and the limited amount of historical data, no assurance can be offered that future costs or savings will emerge according to any estimates contained in this report.

PRESUMED FACTOR

PRESUMED FACTOR FINDING

In accordance with Section 40 of the bill, Deloitte Consulting has estimated the following overall presumed factor which should be applied to each residential property insurer's annual estimate of incurred loss and loss adjustment expenses (LAE) related to sinkhole claims in the State of Florida:

Presumed Factor: 9.6%

As will be discussed below in greater detail, we believe it is not possible at this point in time to actuarially determine the presumed factor for all the impacts of the 2005 and 2006 changes.

It is our professional judgment that we do not have the appropriate and comprehensive data necessary to calculate the sinkhole presumed factor for a number of these changes. However, over the next 18 to 24 months as insurance companies collect additional sinkhole data reflecting the majority of the law changes, we believe it is likely that savings could emerge as a result of the neutral evaluation process, the neutral evaluator's decision being admitted as evidence, payment being made directly to the contractor, reporting to the county clerk, and other important features of the law changes that have not been captured in our 9.6% presumed factor.

It is also important to note that the level of savings above the 9.6% presumed factor will not be known until insurance companies have a chance to experience the neutral evaluation process, understand how judges and juries will react to the neutral evaluator's report, and perform actuarial analysis on future sinkhole claim activity. Since the neutral evaluation process has not been implemented, no information is available on the overall cost of the process because the scope of the neutral evaluation process and the scope of the neutral evaluator's role are not delineated in the statute. We presume once these issues are addressed by the rules adopted by Department of Financial Services (DFS), insurance companies will be in a better position to estimate the impact of the law changes.

PRESUMED FACTOR

II. PRESUMED FACTOR BY SECTION

The documentation for each Section is laid out as follows:

- Section number and title;
- Noteworthy additions;
- Noteworthy deletions;
- Commentary; and
- Selected impact.

Our additions, deletions and commentary have been focused specifically on areas of the provisions of Chapter Law 2006-12 (SB 1980) related to sinkhole losses and Sections 17, 18, 19, 20, and 21 of Chapter Law 2005-11 that we feel are important in the determination of the presumed factor. There are a number of other additions and deletions that we have not commented on in each Section. The purpose of this section of our report is not to reiterate every change, but to focus the reader's attention on additions and deletions that we consider relevant to the work we have been asked to perform.

A complete copy of the provisions of Chapter Law 2006-12 (SB 1980) related to sinkhole losses and Sections 17, 18, 19, 20, and 21 of Chapter Law 2005-11 including deletions, modifications and additions can be obtained from the web site www.myflorida.com under "find an agency" or by directly accessing the web site www.leg.state.fl.us.

The following Section by Section documentation assumes the reader has thoroughly read the provisions of Chapter Law 2006-12 (SB 1980) related to sinkhole losses and Sections 17, 18, 19, 20, and 21 of Chapter Law 2005-11 with coding marking deletions and additions.

PRESUMED FACTOR

Chapter Law 2005-111

Section 17 – Sinkhole Insurance; Definitions

NOTEWORTHY ADDITIONS:

“(a) “Sinkhole” means a landform created by subsidence of soil, sediment, or rock as underlying strata are dissolved by ground water. A sinkhole may form by collapse into subterranean voids created by dissolution of limestone or dolostone or by subsidence as these strata are dissolved.”

“(d) “Engineer” means a person, as defined in s. 471.005, who has a bachelor degree or higher in engineering with a specialty in the geotechnical engineering field. An engineer must have geotechnical experience and expertise in the identification of sinkhole activity as well as other potential causes of damage to the structure.”

“(e) “Professional geologist” means a person, as defined by s. 492.102, who has a bachelor degree or higher in geology or related earth science with expertise in the geology of Florida. A professional geologist must have geological experience and expertise in the identification of sinkhole activity as well as other potential geologic causes of damage to the structure.”

NOTEWORTHY DELETIONS: NONE

COMMENTARY:

Section 17 improved the definition of sinkhole, engineer and professional geologist. Clearer definitions, combined with the uniform standards for testing sinkholes discussed in Section 19 help to standardize the claim settlement process. Through our discussions, we were informed that denials were issued regularly in cases where conclusive evidence existed that the source of the damage was something other than a sinkhole (e.g., leaking pipes, collapsed underground septic tank).

PRESUMED FACTOR

However, based on our discussions with interested parties, it is still believed that a clearer definition of the term “sinkhole” is needed. Currently, there are a number of sinkhole claims being paid that some would argue are not truly sinkhole claims. The typical sinkhole claim does not arise from a “cover collapse” sinkhole where the entire house is suddenly swallowed by the ground. They usually develop from a “cover subsidence” sinkhole where the ground slowly subsides and the property is damaged over a period of time. The latter type of sinkhole claim is not as easy to identify and distinguish from standard non-sinkhole related wear and tear claims which are not covered.

Although discussed in greater detail in Section IV - Observations, we believe it is not possible at this point in time to actuarially determine the savings from Section 17. It is our professional judgment that we do not have the appropriate or comprehensive data necessary to calculate a sinkhole presumed factor other than 0.0% for this section. If data were available, we believe the savings from this section would be minimal.

SELECTED IMPACT: De Minimis Future Savings

Section 18 – Database of Information Relating to Sinkholes; the Department of Financial Services and the Department of Environmental Protection

NOTEWORTHY ADDITIONS:

“(2) The Department of Financial Services, including the employee of the Division of Consumer Services designated as the primary contact for consumers on issues relating to sinkholes, and the Office of the Insurance Consumer Advocate shall consult with the Florida Geological Survey and the Department of Environmental Protection to implement a statewide database of sinkholes and related activity in the state.”

PRESUMED FACTOR

NOTEWORTHY DELETIONS: NONE

COMMENTARY: NONE

SELECTED IMPACT: 0.0%

Section 19 – Standards for Investigation of Sinkhole Claims by Insurers; Nonrenewals

NOTEWORTHY ADDITIONS:

“(2) Following the insurer's initial inspection, the insurer shall engage an engineer or a professional geologist to conduct testing as provided in s. 627.7072 to determine the cause of the loss within a reasonable professional probability and issue a report as provided in s. 627.7073, if:

(a) The insurer is unable to identify a valid cause of the damage or discovers damage to the structure which is consistent with sinkhole loss; or

(b) The policyholder demands testing in accordance with this section or s. 627.7072.

(3) Following the initial inspection of the insured premises, the insurer shall provide written notice to the policyholder disclosing the following information:

(a) What the insurer has determined to be the cause of damage, if the insurer has made such a determination.

(b) A statement of the circumstances under which the insurer is required to engage an engineer or a professional geologist to verify or eliminate sinkhole loss and to engage an engineer to make recommendations regarding land and building stabilization and foundation repair.

(c) A statement regarding the right of the policyholder to request testing by an engineer or a professional geologist and the circumstances under which the policyholder may demand certain testing.

(4) If the insurer determines that there is no sinkhole loss, the insurer may deny the claim. If the insurer denies the claim, without performing testing under s. 627.7072, the policyholder may demand testing by the insurer under s. 627.7072. The policyholder's demand for testing must

PRESUMED FACTOR

be communicated to the insurer in writing after the policyholder's receipt of the insurer's denial of the claim.

(5)(a) Subject to paragraph (b), if a sinkhole loss is verified, the insurer shall pay to stabilize the land and building and repair the foundation in accordance with the recommendations of the engineer as provided under s. 627.7073, and in consultation with the policyholder, subject to the coverage and terms of the policy. The insurer shall pay for other repairs to the structure and contents in accordance with the terms of the policy.

(b) The insurer may limit its payment to the actual cash value of the sinkhole loss, not including underpinning or grouting or any other repair technique performed below the existing foundation of the building, until the policyholder enters into a contract for the performance of building stabilization or foundation repairs. After the policyholder enters into the contract, the insurer shall pay the amounts necessary to begin and perform such repairs as the work is performed and the expenses are incurred. The insurer may not require the policyholder to advance payment for such repairs. If repair has begun and the engineer selected or approved by the insurer determines that the repair cannot be completed within the policy limits, the insurer must either complete the engineer's recommended repair or tender the policy limits to the policyholder without a reduction for the repair expenses incurred.

(6) Except as provided in subsection (7), the fees and costs of the engineer or the professional geologist shall be paid by the insurer.”

NOTEWORTHY DELETIONS:

Removal of old minimum standards for investigation of sinkhole claims by insurers.

COMMENTARY:

Section 19 creates uniform standards for the testing of sinkhole claims. If the claim is initially denied by the insurance company without performing testing under s. 627.7072, the policyholder may demand testing under s. 627.7072 be performed by an engineer or professional geologist at the insurance company's expense.

PRESUMED FACTOR

Although the establishment of uniform standards is often times viewed as a positive step, initially insurers can incur higher costs as the standards are developed and confirmed with their policyholders. Insurers may also incur higher costs going forward when engineers or professional geologists are used in situations that used to be handled by experienced sinkhole claim adjusters without professional designations. Additionally, insureds will push for the meeting of minimum standards, which may result in higher costs than, would have been incurred before the standards were in place.

Although discussed in greater detail in Section IV - Observations, we believe it is not possible at this point in time to actuarially determine the costs from Section 19. It is our professional judgment that we do not have the appropriate or comprehensive data necessary to calculate a sinkhole presumed factor other than 0.0% for this section.

SELECTED IMPACT: De Minimis Future Cost

PRESUMED FACTOR

Section 20 – Testing Standards for Sinkholes

NOTEWORTHY ADDITIONS:

Added testing standards for the engineer and professional geologist.

NOTEWORTHY DELETIONS: NONE

COMMENTARY: NONE

SELECTED IMPACT: NONE

Section 21 – Sinkhole Reports

NOTEWORTHY ADDITIONS:

“(a) Sinkhole loss is verified if, based upon tests performed in accordance with s. 627.7072, an engineer and a professional geologist issue a written report and certification stating:

1. That the cause of the actual physical and structural damage is sinkhole activity within a reasonable professional probability.
2. That the analyses conducted were of sufficient scope to identify sinkhole activity as the cause of damage within a reasonable professional probability.
3. A description of the tests performed.
4. A recommendation by the engineer of methods for stabilizing the land and building and for making repairs to the foundation.

(b) If sinkhole activity is eliminated as the cause of damage to the structure, the engineer and professional geologist shall issue a written report and certification to the policyholder and insurer stating:

1. That the cause of the damage is not sinkhole activity within a reasonable professional probability.
2. That the analyses and tests conducted were of sufficient scope to eliminate sinkhole activity as the cause of damage within a reasonable professional probability.
3. A statement of the cause of the damage within a reasonable professional probability.
4. A description of the tests performed.”

PRESUMED FACTOR

NOTEWORTHY DELETIONS:

COMMENTARY:

Section 21 will likely increase insurance company costs related to the issuance of a written report and certification by an engineer or professional geologist. Although larger insurers appear to be addressing most of the above requirements, even before the passage of the law, the formal requirements do increase costs in those situations where the insurer felt there was no need for completing a written report in the past (e.g., collapsed septic tank was obvious cause of loss).

Although discussed in greater detail in Section IV - Observations, we believe it is not possible at this point in time to actuarially determine the costs from Section 21. It is our professional judgment that we do not have the appropriate or comprehensive data necessary to calculate a sinkhole presumed factor other than 0.0% for this section.

SELECTED IMPACT: De Minimis Future Cost

Chapter Law 2006-12

Section 25 – Sinkhole Insurance; Definitions

NOTEWORTHY ADDITIONS:

“A policy for residential property insurance may include a deductible amount applicable to sinkhole losses equal to 1 percent, 2 percent, 5 percent, or 10 percent of the policy dwelling limits, with appropriate premium discounts offered with each deductible amount.”

NOTEWORTHY DELETIONS: NONE

COMMENTARY:

Section 25 proposes 4 different deductible levels as a percent of the policy dwelling limits. Assuming actuarial pricing with appropriate premium discounts offered for each deductible option (i.e., premium credit equals expected losses eliminated by the deductible), deductibles could ultimately lead to reduced loss adjustment expenses if the deductibles reduces policyholder interest in pursuing sinkhole claims.

However, unlike the mandatory deductibles required by the catastrophe windstorm pool, the current sinkhole law only states that insurers “may” offer deductibles. At this point in time, no data is available to determine the impact of deductibles on loss adjustment expenses or the filing of sinkhole claims. Given the level of policyholder uncertainty surrounding whether a claim should be classified as a sinkhole claim or not, and the potential remediation costs that could be involved, we believe it is likely that homeowners with deductibles would still require insurers to utilize the services of a professional engineer and a professional geologist in determining the cause of the actual physical and structural damage.

Although discussed in greater detail in Section IV - Observations, we believe it is not possible at this point in time to actuarially determine the savings from Section 25. It is our professional

PRESUMED FACTOR

judgment that we do not have the appropriate or comprehensive data necessary to calculate a sinkhole presumed factor other than 0.0% for this section.

SELECTED IMPACT: De Minimis Future Savings

Section 26 – Standards for Investigation of Sinkhole Claims by Insurers; nonrenewals.

NOTEWORTHY ADDITIONS:

“Upon the insurer’s obtaining the written approval of the policyholder and any lien holder, the insurer may make payment directly to the persons selected by the policyholder to perform the land and building stabilization and foundation repairs. The decision by the insurer to make payment to such persons does not hold the insurer liable for the work performed.”

NOTEWORTHY DELETIONS: NONE

COMMENTARY:

Section 26 allows the insurer, with the written permission of the policyholder and lien holder, to make payments directly to the persons selected to perform the land and building stabilization and foundation repairs. This may reduce the chance that the policyholder will receive a direct payment from the insurer and use all or a portion of the proceeds for purposes other than repairing the home.

Although discussed in greater detail in Section IV - Observations, we believe it is not possible at this point in time to actuarially determine the savings from Section 26. It is our professional judgment that we do not have the appropriate or comprehensive data necessary to calculate a sinkhole presumed factor other than 0.0% for this section

SELECTED IMPACT: De Minimis Future Savings

PRESUMED FACTOR

Section 27 – Testing Standards for Sinkholes

NOTEWORTHY ADDITIONS: NONE

NOTEWORTHY DELETIONS: NONE

COMMENTARY: NONE

SELECTED IMPACT: 0.0%

Section 28 – Sinkhole Reports

NOTEWORTHY ADDITIONS:

“cause of distress to the property”

“including the legal description of the real property and the name of the property owner, with the county clerk of court”

NOTEWORTHY DELETIONS:

“verification or elimination of a sinkhole loss”

“property appraiser”

COMMENTARY:

Section 28 now requires the professional engineer or professional geologist to state the cause of distress to the property. Currently, these professionals can provide findings that may appear vague and open to multiple interpretations (e.g., stating that a sinkhole may not be ruled out with 100 percent certainty).

In addition, a copy of the report and certification must be filed with the county clerk of court, who shall record the report and certification. Information provided to the county clerk, unlike information provided to the county appraiser, will show up on the title company search during the title verification process. Title insurance assures a purchaser of real estate (and the lender) that the seller has clear ownership – or title – to the property and can transfer it to the purchaser. The title policy does not require that title problems be fixed, only that lenders or owners be compensated in the event of a problem that is covered under the policy. Possible title defects

PRESUMED FACTOR

include errors or omissions in deeds, forgery, mistakes in examining records, undisclosed or missing heirs, and liens (e.g., for unpaid taxes, by contractors, etc.).

By making the process more transparent for title insurers, lenders and future home buyers, homeowners selling their property with sinkhole issues may face a reduced selling price if they are unable to prove that prior insurance company payments have been properly used to stabilize the ground and repair the home.

Although discussed in greater detail in Section IV - Observations, we believe it is not possible at this point in time to actuarially determine the savings from Section 28. It is our professional judgment that we do not have the appropriate or comprehensive data necessary to calculate a sinkhole presumed factor other than 0.0% for this section.

SELECTED IMPACT: De Minimis Initial Savings, Potential Future Savings

PRESUMED FACTOR

Section 29 – Alternative Procedure for Resolution of Disputed Sinkhole Insurance Claims

NOTEWORTHY ADDITIONS:

“(3) Following receipt of the report provided under s.627.7073 or the denial of a claim for a sinkhole loss, the insurer shall notify the policyholder of his or her right to participate in the neutral evaluation program under this section.”

“(4) Neutral evaluation is nonbinding, but mandatory if requested by either party.”

“(6) The insurer shall pay the costs associated with the neutral evaluation.”

“(10) Evidence of an offer to settle a claim during the neutral evaluation process, as well as any relevant conduct or statements made in negotiations concerning the offer to settle a claim, is inadmissible to prove liability or absence of liability for the claim or its value, except as provided in subsection (13).”

“(12) For matters that are not resolved by the parties at the conclusion of the neutral evaluation, the neutral evaluator shall prepare a report stating that in his or her opinion the sinkhole loss has been verified or eliminated and, if verified, the need for and estimated costs of stabilizing the land and any covered structures or buildings and other appropriate remediation or structural repairs.”

“(13) ... The neutral evaluator’s written recommendation is admissible in any subsequent action or proceeding relating to the claim or to the cause of action giving rise to the claims.”

“(14) If the neutral evaluator first verifies the existence of a sinkhole and, second, recommends the need for and estimates costs of stabilizing the land and any covered structures or buildings and other appropriate remediation or structural repairs, which costs exceed the amount that the insurer has offered to pay the policyholder, the insurer is liable to the policyholder for up to \$2,500 in attorney’s fees for the attorney’s participation in the neutral evaluation process.”

“(15) If the insurer timely agrees in writing to comply and timely complies with the recommendation of the neutral evaluator, but the policyholder declines to resolve the matter in accordance with the recommendation of the neutral evaluator pursuant to this section:

PRESUMED FACTOR

(a) The insurer is not liable for extra-contractual damages related to a claim for a sinkhole loss but only as related to the issues determined by the neutral evaluation process....

(b) The insurer is not liable for attorney’s fees under s.627.428 or other provisions of the insurance code unless the policyholder obtains a judgment that is more favorable than the recommendation of the neutral evaluator.”

NOTEWORTHY DELETIONS: NONE

COMMENTARY:

Section 29 adds the option for either the policyholder or insurer to request a neutral evaluation process (NEP) with DFS. A neutral evaluator, selected from a list of certified neutral evaluators, determines the cause of damage to a property, assesses the extent of the damage and estimates the cost of repairing the damage. The neutral evaluator prepares a report that will verify or eliminate sinkhole as the cause of loss. The neutral evaluator’s report is allowed to be admitted as evidence if the claim proceeds to litigation.

Page 34 and 35 of our report display the NEP in flow chart form. The following paragraphs walk the reader through the NEP while identifying areas for future consideration.

Depending upon the successful implementation of the NEP, we believe there could be an eventual reduction in the number of filed sinkhole claims.

Impact A: Plaintiff Attorney Involvement

Depending on successful implementation of the NEP, the impact on judges and juries of neutral evaluator’s admissible report, and how well Section 29 limits the ability of a policyholder to recover attorney’s fees in certain circumstances, the level of plaintiff attorney involvement could change. For instance, plaintiff attorney involvement could diminish if the neutral evaluator’s admissible report is relied upon heavily by judges and juries (i.e., truly treated as a neutral opinion). Plaintiff attorney involvement could also diminish if

PRESUMED FACTOR

judgments favor insurance companies and the insurer is not liable for attorney fees under s.627.428 F.S. If active plaintiff attorney recruitment of homeowners decreases due to reduced insurance proceeds (e.g., removal of attorney sinkhole billboards and door to door advertising), the number of filed sinkhole claims could decrease.

As is shown on page 34, the homeowner files a sinkhole claim with their insurance company. Upon receipt of the sinkhole claim, the insurer inspects the insured's premises to determine if there has been physical damage to the structure which may be the result of sinkhole activity. The inspection may vary from a simple physical inspection on claims that appear to be non-sinkhole claims, to more involved testing procedures such as deep boring which is used more frequently on paid sinkhole claims.

If the insurer accepts the sinkhole claim, a report documenting the findings is provided and the insured can agree or disagree with the repair estimate. If the insurer denies the sinkhole claim (e.g., list cause of loss as settling, decay, soil settlement, etc.), the insured can agree or disagree with the denial.

Impact B: Percentage of Sinkhole Claims Denied

According to the Florida State University study, northern regions of the state had the highest denial rates with 100 percent of the claims being denied. In the central portion of the state, claim denial rates varied from 56 percent to 88 percent of submitted claims. The report also noted that nearly 50 percent of Florida counties have 100 percent denial rates.

At this point in time, we are unable to determine if the percentage of sinkhole claims denied by insurance companies will change as a result of the NEP. However, depending on successful implementation of the process and the impact on judges and juries of neutral evaluator's admissible report, two things could impact denial rates:

- 1) Insurers could become more comfortable with denying claims that were accepted in the past based purely on cost concerns and their objective to reduce sinkhole exposure.

PRESUMED FACTOR

- 2) Plaintiff attorney involvement in these types of claims could diminish, reducing the number of unsupportable claims.

When the insurer denies the sinkhole claim and shares the consumer information pamphlet on the NEP with the insured, the percentage of insureds who agree or disagree with the insurance company's denial may change.

Impact C: Percentage of Claims Insured Agrees With Denial

No information was available on the percentage of sinkhole claims where the insured agrees with the insurance company's denial. Therefore, we are unable to determine if the percentage will change as a result of the NEP. However, it appears likely that the NEP will, at the very least, encourage policyholders to consider pursuing their claims beyond the first denial by the insurance company and to invoke the NEP because, among other things, (i) the insurance company bears the full cost of paying for the NEP and therefore there is no downside to the policyholder in invoking the NEP and (ii) the policyholder may feel more comfortable invoking the NEP without the benefit (and attendant cost) of private counsel because the Department is required to provide the policyholder with access to a consumer affairs specialist for consultation.

On page 35, we display the start of the neutral evaluation process. For illustration purposes, we have assumed that in situations where the insurer denied the claim without performing testing under s. 627.7072, the insured would have demanded testing be performed under s.627.7072 by the insurer before entering the NEP.

Impact D: Cost of NE Process

Since the NE process has not been implemented, no information is available on the overall cost of the NE process to the insurance company because the scope of the neutral evaluation process and the scope of the neutral evaluator's role are not delineated in the statute. We

PRESUMED FACTOR

presume those issues will be addressed by the rules adopted by the (DFS). It should be noted that Section 29 requires the insurer pay all costs associated with the NE process.

In addition, the insurance company must provide a consumer information pamphlet on the NE process to the insured and notify them of their right to participate in the NEP. These changes will likely result in additional costs because of increased policyholder awareness.

Upon completion of the NEP, the neutral evaluator prepares a report verifying or eliminating the sinkhole claim. The insured, at this point in time, can choose to accept the findings of the neutral evaluator and settle the claim or proceed to litigation. Depending upon the successful implementation of the NEP, we believe there could be three areas impacting sinkhole related costs:

Impact E: Impact of Allowing NE's Decision to be Admitted as Evidence

The purpose of the neutral evaluator is to provide verification as to the presence of a sinkhole, the plan for remediation and estimate the cost to remediate. Because the neutral evaluator's report is admissible as evidence in any further legal action, the revisions to the law will likely reduce the frequency of litigation.

PRESUMED FACTOR

Impact F: Impact of Bad Faith Changes

If the insurer agrees in writing with the neutral evaluator's assessment and timely complies with the recommendations, the insurer is no longer liable for extra-contractual damages related to the sinkhole loss with respect to the issues determined by the neutral evaluation process. However, we note that it is the position of Citizens that it is exempt from bad faith liability due to the language of section 627.351(6)(i), which is part of its enabling statute. If Citizens is, in fact, exempted from bad faith liability under its enabling statute, then the changes to Section 29 eliminating bad faith liabilities under certain circumstances would have minimal impact on Citizens. Given the number of policies that have moved from other insurance companies to Citizens, the savings to insurance companies from this change would likely be minimal. Unfortunately, we were unable to obtain credible information on the percentage of sinkhole claim payments resulting from bad faith allegations made by policyholders.

Impact G: Impact of Limited Fee Shifting

In Florida, the general rule is that each party pays its own attorneys' fees. This is known as the "American Rule." In England, the loser always pays the winner's legal fees. There are only two exceptions. First, a statute may make attorneys' fee available to a prevailing party in a certain type of lawsuit. Second, a contractual provision may allow the prevailing party to recover attorneys' fees.

With respect to suits between an insurance company and a policyholder, Florida law (section 627.428) requires that the insurance company pay reasonable attorneys' fees to a policyholder in all lawsuits in which the policyholder prevails. Section 29 now provides that the "insurer is not liable for attorney's fees under s.627.428 or other provisions of the insurance code unless the policyholder obtains a judgment that is more favorable than the recommendation of the neutral evaluator."

PRESUMED FACTOR

Although Section 29 does not make a policyholder liable to pay an insurance company's fees, it does take away the right for the policyholder to recover attorneys' fees in certain circumstances. The significance of this change cannot be overstated. If the neutral evaluator does not decide in favor of the policyholder (or does not give the policyholder everything she or he wants), then the policyholder has a solid disincentive to go to court because the policyholder can only recover attorney's fees if the jury verdict exceeds the relief recommended by the neutral evaluator.

Given the fact that the NEP is mandatory if requested by the insurance company or policyholder, we believe that Section 29 will result in reduced plaintiff attorney involvement for three reasons. First, in cases where the neutral evaluator determines the loss was not caused by a sinkhole, the insurance company will have a greater likelihood of carrying its burden of proof at trial to establish that the cause of loss was excluded as coverage. Secondly, the limited fee shifting features of Section 29, combined with the admissibility of the neutral evaluators report, will likely reduce plaintiff attorney involvement. Lastly, policyholders will be more aware that they can proceed through the NEP without having to pay attorney fees. The following illustrates a range of possible insurance company savings from Section 29 on plaintiff attorney fees expressed as a percentage of sinkhole indemnity and LAE payments:

PRESUMED FACTOR

SECTION 29 PRESUMED FACTOR CALCULATION

LOW SAVINGS ESTIMATE
25% OF PLAINTIFF ATTORNEY FEES ELIMINATED

$$PF = 1 - \frac{IND_{X-PAF} + PAF \times (1 - 25\%) + LAE}{IND \text{ AND } LAE} = \boxed{4.8\%}$$

HIGH SAVINGS ESTIMATE
75% OF PLAINTIFF ATTORNEY FEES ELIMINATED

$$PF = 1 - \frac{IND_{X-PAF} + PAF \times (1 - 75\%) + LAE}{IND \text{ AND } LAE} = \boxed{14.4\%}$$

ASSUMPTIONS:

(1) INDEMNITY	\$1.00
(2) LAE/INDEMNITY RATIO	20%
(3) LAE	\$0.20 = (1) x (2)
(4) IND AND LAE	\$1.20
(5) PAF	\$0.23
(6) IND_{X-PAF}	\$0.77
(7) PAF/ IND_{X-PAF} RATIO	30% = (5) / (6)

IND = INDEMNITY

LAE = LOSS ADJUSTMENT EXPENSE

PAF = PLAINTIFF ATTORNEY FEES

In order to determine the above range of savings, we assumed the following:

1. Loss adjustment expenses represent approximately 20% of indemnity dollars paid by insurance companies based on our review of available industry data
2. Plaintiff attorney fees, which are included in the indemnity payments made by insurance companies, represent approximately 30% of non plaintiff attorney fee indemnity payments based on our legal review and consideration of Florida Rules of Professional Conduct for Lawyers - Rule 4-1.5 "Fees and Costs for Legal Services."
3. A range of savings on plaintiff attorney fees from 25% to 75% of the current plaintiff attorney fees paid by insurance companies based on our understanding of the changes proposed by Section 29.

PRESUMED FACTOR

At a minimum, we believe insurance companies will see a reduced expenditure on plaintiff attorney fees of 25% driven by the assumptions discussed above. However, we believe the level of expenditure on plaintiff attorney fees could decrease in excess of that level driven by reduced plaintiff attorney interest and consumer awareness in situations where policyholders may ask plaintiff attorney's to charge hourly rates before the NEP, in order to avoid the 33 1/3 percent fees on recoveries up to \$1 million paid by insurance companies. Given the uncertainty in selecting a number in this range of possible savings estimates, we have selected the average of 9.6% as the presumed factor for savings attributable to reduced plaintiff attorney fees.

We note that additional costs or savings may arise from this section. However, we believe it is not possible at this point in time to actuarially determine the savings or costs from these other items. It is our professional judgment that we do not have the appropriate or comprehensive data necessary to calculate a sinkhole presumed factor other than 0.0% for these other items.

However, over the next 18 to 24 months as insurance companies and plaintiff attorneys have a chance to experience the NEP, understand how judges and juries will react to the neutral evaluator's report and perform actuarial analysis on future sinkhole activity as claim data is collected, we believe it is likely that additional costs or savings could emerge as a result of these impacts.

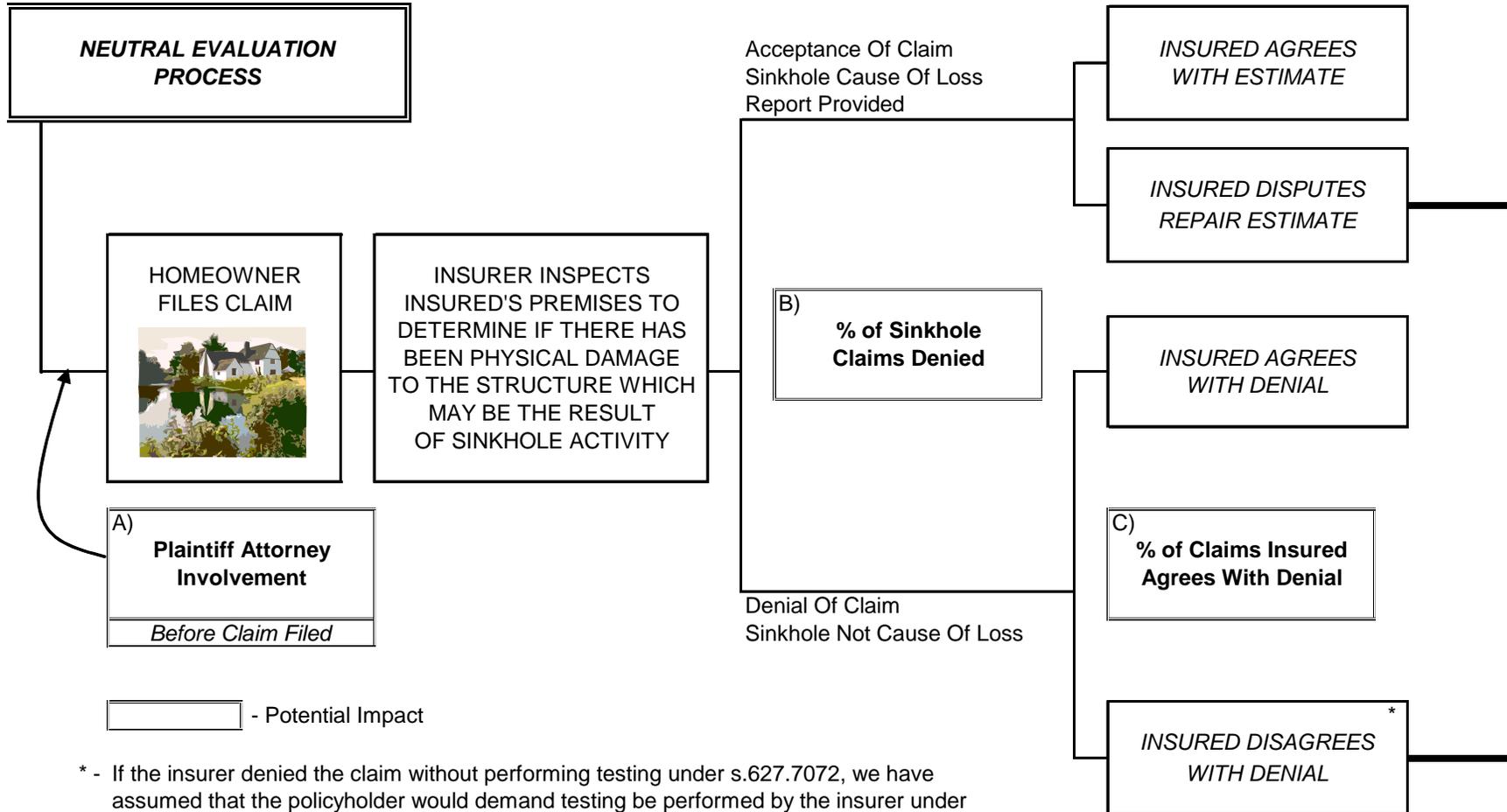
SELECTED IMPACT: 9.6%, Potential Future Savings

PRESUMED FACTOR

SECTION 40

SHEET 1

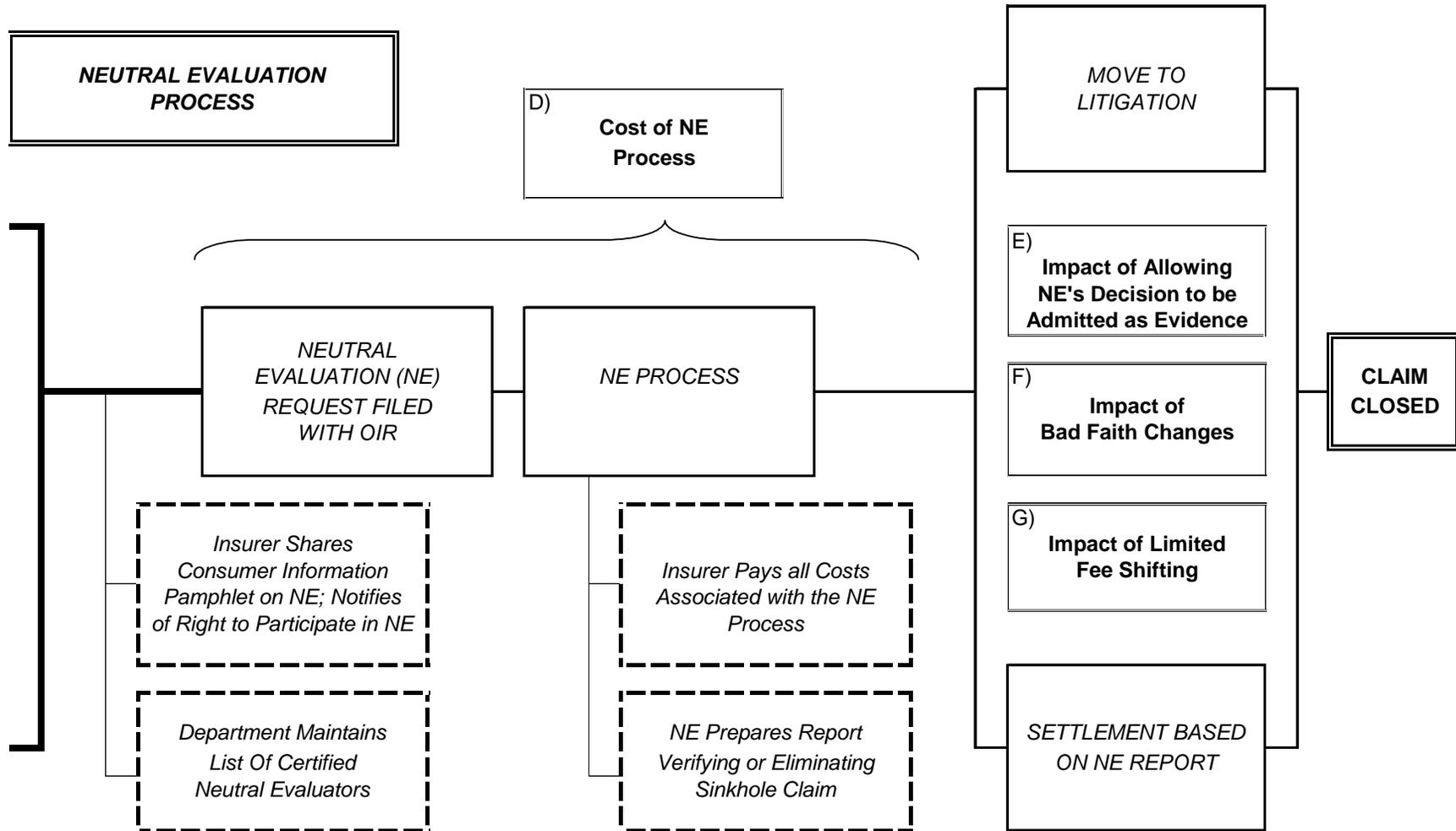
"PRESUMED FACTOR (PF)" - SAVINGS FLOW SECTION 29 - ALTERNATIVE PROCEDURE FOR RESOLUTION



PRESUMED FACTOR

SECTION 40 "PRESUMED FACTOR (PF)" - SAVINGS FLOW SECTION 29 - ALTERNATIVE PROCEDURE FOR RESOLUTION

SHEET 2



PRESUMED FACTOR

III. PRESUMED FACTOR SUMMARY MATRIX

Chapter Law 2005-111	
Section 17 – Sinkhole Insurance; Definitions.....	0.0%
Section 18 – Database of Information Relating to Sinkholes	0.0%
Section 19 – Standards for Investigation	0.0%
Section 20 – Testing Standards for Sinkholes	0.0%
Section 21 – Sinkhole Reports.....	0.0%
Chapter Law 2006-12	
Section 25 – Sinkhole Insurance; Definitions.....	0.0%
Section 26 – Standards for Investigation	0.0%
Section 27 – Testing Standards for Sinkholes	0.0%
Section 28 – Sinkhole Reports.....	0.0%
Section 29 – Alternative Procedure for Resolution	9.6%
Overall Presumed Factor	9.6%

PRESUMED FACTOR

IV. OBSERVATIONS

Observations

This section of the report addresses issues that may span multiple Sections or require a more detailed discussion than presented above.

- **Actuarial Standards of Practice (ASOP)**

In the American Academy of Actuaries “Introduction to the Actuarial Standards of Practice”⁹, the document states:

“Actuaries are expected to take a good faith approach in applying ASOPs, exercising good judgment and common sense; it would be inappropriate for any user of an ASOP to make a strained interpretation of the provisions of the ASOP.

Actuaries should observe those ASOPs that are relevant to the task at hand; not all ASOPs will apply. An ASOP should not be interpreted as having applicability beyond its stated scope and purpose. Most, but not all, of the ASOPs are task-specific, dealing with particular kinds of professional services performed by actuaries. A few ASOPs, however, deal more broadly with particular aspects of many types of actuarial assignments (for example, ASOP No. 23, Data Quality). Actuaries are responsible for identifying the ASOPs that apply to the task at hand. The Academy’s Council on Professionalism publishes advisory Applicability Guidelines to assist actuaries in identifying the ASOPs that may be relevant.”

As defined in ASOP No. 23:

⁹ From the American Academy of Actuaries web site www.actuary.org.

PRESUMED FACTOR

Appropriate Data - For purposes of data quality, data are appropriate if they are suitable for the intended purpose of an analysis and relevant to the system or process being analyzed.

Comprehensive Data - For purposes of data quality, data obtained from inventory or sampling methods are comprehensive if they contain sufficient data elements or records needed for the analysis.

ASOP No. 23 also notes:

“If, in the actuary’s professional judgment, it is not appropriate to perform a review of the data, the actuary should disclose that the actuary has not done such a review and should disclose any resulting limitation on the use of the actuarial work product.”

It is our professional judgment that we do not have the appropriate or comprehensive data necessary to calculate a sinkhole presumed factor other than 0.0% for a number of the law changes discussed above by section.

- **Ability to Calculate the Presumed Factor**

We have calculated a presumed factor of 9.6% reflecting reduced expenditures on plaintiff attorney fees in Section 29. However, we are unable to calculate a presumed factor as of September 1, 2006 for a number of the law changes discussed above by section based on the following:

Actuarial Standards of Practice

Appropriate and comprehensive data does not exist as of September 1, 2006.

PRESUMED FACTOR

Availability of Data

Citizens and State Farm did their best to provide us with sinkhole data during our July 11, 2006 through August 21, 2006 analysis period (see Background section of report).

Unfortunately, no individual claim level detail was available during the analysis period that would help us estimate the impact of the 2005 and 2006 law changes. For example, the data provided by the insurance companies does not include any credible sinkhole experience that reflects the neutral evaluation process, trends on how judges and juries will react to the neutral evaluator's report, trends on the level of plaintiff attorney involvement, trends in denial rates, the impact of deductibles, the impact of payments made directly to contractors, the impact of certifications filed with the county clerk of court, etc.

It is our opinion that a sufficient amount of time has not passed since the 2005 and 2006 law changes were passed to evaluate a number of the changes. However, over the next 18 to 24 months, as insurance companies collect additional sinkhole data, we do believe that savings in excess of the presumed factor could emerge as a result of the neutral evaluation process, the neutral evaluator's decision being admitted as evidence, payment being made directly to the contractor, reporting to the county clerk, and other important features of the law changes. Insurance companies should reflect any savings in excess of the presumed factor in future rate filings.

Uncertainty Regarding the Structure of Neutral Evaluation Process

Since the neutral evaluation process has not been implemented, no information is available on the overall cost of the process because the scope of the neutral evaluation process and the scope of the neutral evaluator's role are not delineated in the statute. Once these issues are addressed by DFS and rules they adopt, insurance companies will be in a better position to estimate the impact of the law changes.

PRESUMED FACTOR

Dramatic increase in the number of sinkhole claims

As noted in the Background section, Citizens' sinkhole loss experience has deteriorated from just 9 claims reported in 2002 to 632 claims in 2005. State Farm's loss experience has deteriorated from just 6 claims in 1994 to in excess of 400 claims in 2002, 2003 and 2004.

It was noted in our interviews that the rise in claims is likely correlated with the dramatic increase in policyholder awareness of "sinkholes" driven by attorney advertising (e.g., door to door pamphlets, billboards, internet web sites) and "word of mouth" about insurance company payments.

The significant upswing in claims makes it difficult to use the historical data for estimating the impact of the 2005 and 2006 law changes. With claims jumping from 9 claims reported in 2002 to 632 claims in just four years, the Citizen's data lacks stability and credibility.

Although State Farm has a few more years of data, their data exhibits the same challenges from a stability and credibility perspective.

- **Application of the Presumed Factor**

The presumed factor should be applied to each residential property insurer's annual estimate of incurred loss and loss adjustment related sinkhole claims in the state of Florida.

Data provided by Citizens shows that 95 percent of all sinkhole claims and 98 percent of all sinkhole loss and loss adjustment expense have been reported in Pasco, Hernando, Pinellas and Hillsborough counties. Given the heavy concentration of sinkholes in certain Florida counties, we believe the presumed factor should be applied to each insurance company's actual sinkhole loss and loss adjustment expense data. Upon calculating the savings, the insurance company could then express the savings as a one decimal place percentage to base rates.

PRESUMED FACTOR

We don't believe it is appropriate to develop a presumed factor expressed in the form of a one decimal place percentage adjustment to base rates that gets applied equally to all counties. This approach would overstate the savings for counties with no sinkhole exposure (e.g., northern counties) and understate the savings for counties with significant sinkhole exposure (e.g., sinkhole alley).

- **Data gathering**

In order for insurance companies to analyze any savings that could emerge in excess of the presumed factor, insurers must monitor and track sinkhole loss and loss adjustment expense. For insurers not tracking sinkhole related information, it would be important to begin separately coding and tracking sinkhole losses.

We also recognize that some insurance companies may have little or no credible sinkhole data for purpose of calculating future savings. In these situations, the company may need to reach out to the OIR or review savings calculations filed by other insurance companies like Citizens with more credible data.

- **Rate filing considerations**

It is up to each insurance company with direct written premium in the State of Florida to consider their own independent analysis and review of their book of business over the next 18 to 24 months in order to determine whether the presumed factor produces rates that are excessive, inadequate, or unfairly discriminatory.

- **Constitutionality**

The constitutionality of the new law does not appear to be an issue, although there is always the possibility of legal challenges, including constitutional challenges, to new legislation. Our report assumes that the provisions of the 2005 and 2006 law changes are valid as enacted and that all provisions of the new legislation will be enforced by the courts.

PRESUMED FACTOR

- **Determining who will be the Neutral Evaluator**

DFS is currently in the process of developing and maintaining a list of certified neutral evaluators. We have not reviewed or discussed the process behind how the neutral evaluators are selected.

- **Valid Claims**

We have not investigated or attempted to determine the percentage of sinkhole claims in the data we received that have been classified by some individuals as fraudulent claims. However, we understand that the significant spike in the number of sinkhole claim payments since 2002 likely includes a number of sinkhole payments that may not be true sinkhole claims.

Based on our interviews, a majority of the sinkhole claims in Pasco County come from housing developments that were built over thirty years ago. Less stringent building codes, combined with less than adequate building construction by contractors and proactive advertising by plaintiff attorneys, have resulted in some sinkhole payments that are actually the result of settlement or wear and tear.

Lastly, given the cost of defending and settling sinkhole claims, some insurers have chosen to pay policy limits on non sinkhole claims in order to avoid future exposure. Paying policy limits allows the insurance company to cancel the homeowner's policy.

- **Tracking Sinkhole Claims**

Prudence needs to be taken when determining the applicability of a presumed factor to each individual insurer's sinkhole loss experience. Claims data for each insurer may be tracked by either the first report of sinkhole claim or by the first verification of sinkhole activity. The insurer must be careful in tracking all costs associated with claim from inception to accurately track sinkhole loss adjustment expense properly. Additionally, any claim initially

PRESUMED FACTOR

reported as a sinkhole loss, and investigated as a sinkhole loss, whether a sinkhole is verified or ruled out, the loss adjustment expense associated with the claim should be tracked as a sinkhole.

- **Tendering Policy Limits**

We note that when examining the percentage of sinkhole claims that have reached policy limits, this percentage could vary significantly by insurer based on their individual claims settlement practices. Most insurers have the ability to tender policy limits to a claimant in order to have the option to non-renew the insured. This ability provides a negotiation point to the insurer when settling claims. Some insurers may not use this method of negotiating and therefore display a lower ratio of claims settling at policy limits. Since Citizens serves as the insurer of last resort, tendering policy limits to have the option to non-renew is not applicable. However, if the insured does not make the repairs, Citizens does not have to insure the property.

- **Bad Faith**

We observe that it is the position of Citizens that it is exempt from bad faith liability due to the language of section 627.351(6)(i), which is part of its enabling statute. We express no opinion on the meaning of the statute. We also note that no court in Florida has yet ruled on this issue. If Citizens is, in fact, exempted from bad faith liability under its enabling statute, then the changes to Section 29 eliminating bad faith liabilities under certain circumstances would have minimal impact on Citizens.

- **Sinkhole Testing Procedures**

There are a number of testing procedures used to verify the existence of sinkholes. These procedures include shallow boring, deep boring, ground penetrating radar, physical inspections, penetrometer probes, moisture testing, electro-resistivity testing and floor slab

PRESUMED FACTOR

surveys.¹⁰ Currently, shallow boring is more commonly used with denied claims, whereas deep boring is used more frequently for paid claims. During the course of our analysis, we were unable to determine whether the costs of these procedures or the level of utilization will change as a result of the 2005 and 2006 law changes. In addition, we make no opinion on the usefulness or reliability of these procedures in verifying the existence of sinkholes.

- **Sinkhole Definition**

Most residential insurance policies in Florida exclude coverage for losses caused by "earth movement," which includes earthquakes, tremors, landslides, mine subsidence, earth sinking, earth rising, and other natural events. "Sinkhole activity" is expressly excluded from the definition of earth movement and losses caused by sinkhole activity are required by statute to be covered. But there is concern that, unless the definition of sinkhole activity is clear and unambiguous, there may be a tendency for courts to find coverage that otherwise does not exist because the insurer is unable definitively to eliminate sinkhole activity (as opposed to other earth movement) as the cause of the loss.

The 2005 law revised the definition "sinkhole activity" to make it more explicit. The new definition is as follows: "Sinkhole activity" means settlement or systematic weakening of the earth supporting ... property only when such settlement or systematic weakening results from movement or raveling of soils, sediments, or rock materials into subterranean voids created by the effect of water on limestone or similar rock formation."

It remains to be seen whether this definition will be sufficient to eliminate confusion about whether a loss was caused by covered "sinkhole activity" as opposed to uncovered "earth movement." In the event that neutral evaluators and courts continue to face difficulty in determining, in essence, what losses were not caused by sinkhole activity, commentators

¹⁰ For a more detailed discussion of testing procedures and levels of use, please refer to the April 2005 Florida State University report titled "Insurance Study of Sinkholes"

PRESUMED FACTOR

have suggested that the Legislature consider further revisions to narrow the definition of "sinkhole activity."

- **Competition**

During our conversations, more than one individual pointed out that the 2005 and 2006 law changes were partially motivated by the desire to increase competition and improve the availability of homeowners coverage in sinkhole counties where rate increases have been significant over the past few years. We were unable to determine whether the law changes will increase competition.

- **Neutral Evaluator's Role**

It is unclear in Section 29 to what extent the neutral evaluator can conduct independent testing especially in light of the provision that the insurance company has to pay all costs. DFS adopted rules will have an impact on the insurance company's future estimates of the cost of neutral evaluation process.

PRESUMED FACTOR

V. APPENDIX

PRESUMED FACTOR

APPENDIX A – Homeowners Insurance 101¹¹

- Coverage A (Dwelling) applies to the structure you inhabit. This would cover the dwelling, attached structures (such as a garage) and permanently installed property (such as wall-to-wall carpeting).
- Coverage B (Other structures) applies to other structures on your property. This would cover a tool shed or a garage that is not permanently attached to your home.
- Coverage C (Personal property) applies to the content of the dwelling. This area would cover your property anywhere in the world. There are dollar limits on specific items that you should be aware of because if your property exceeds these amounts, or no amount is specified, you should cover them for an agreed amount.
- Coverage D (Loss of use) applies when the dwelling is uninhabitable due to a covered loss. It would cover additional living expenses (those necessary to maintain a normal standard of living) or fair rental value (income lost from renters).
- Coverage E (Personal Liability, Bodily Injury and Property Damage) is similar to Personal Property coverage. This covers you when you are on or off your premises and will cover you when you are legally responsible for an act that causes damage to someone else's person or property.
- Coverage F (Medical Payments) covers medical expenses stemming from injuries that occur to others while they are on your premises.
- Limits of liability - For basic homeowners policies, a specific minimum amount of coverage is required for each of the major property coverages, based on the primary amount of insurance selected.

Coverage A (Dwelling) = Primary limit

Coverage B (Other Structures) = 10% of Coverage A limit

Coverage C (Personal Property) = 50% of Coverage A limit

Coverage D (Loss of use) = 20% of Coverage A limit¹²

¹¹ For further detail, please refer to the Travelers Homeowners Insurance 101 web site (www.travelers.com)

¹² Actual Coverage B, C and D limits may vary by insurance company

PRESUMED FACTOR

APPENDIX B – Florida County Map¹³¹⁴

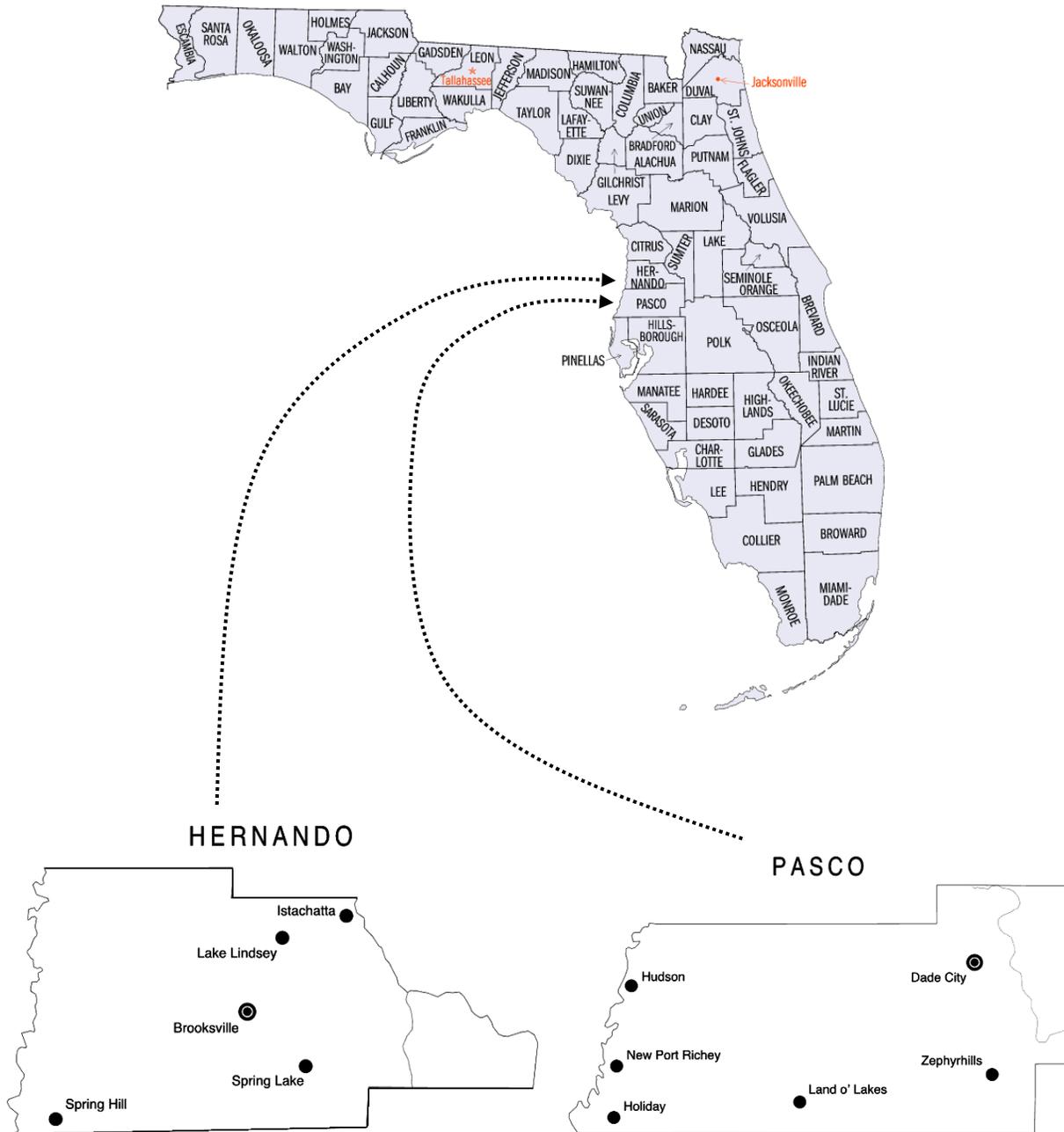


¹³ From U.S. Census Bureau web site http://quickfacts.census.gov/qfd/maps/florida_map.html

¹⁴ Please refer to the January 2006 Insurance Services Office, Inc. report titled “Territorial Boundaries for Residential Coverages in Florida” for the development of a proposed standard rating territory plan to be used by all property and casualty insurers for residential property insurance. The report displays detailed maps for each Florida county. The report can be found at www.floir.com/LegislativeAffairs/2006_reports_studies.htm.

PRESUMED FACTOR

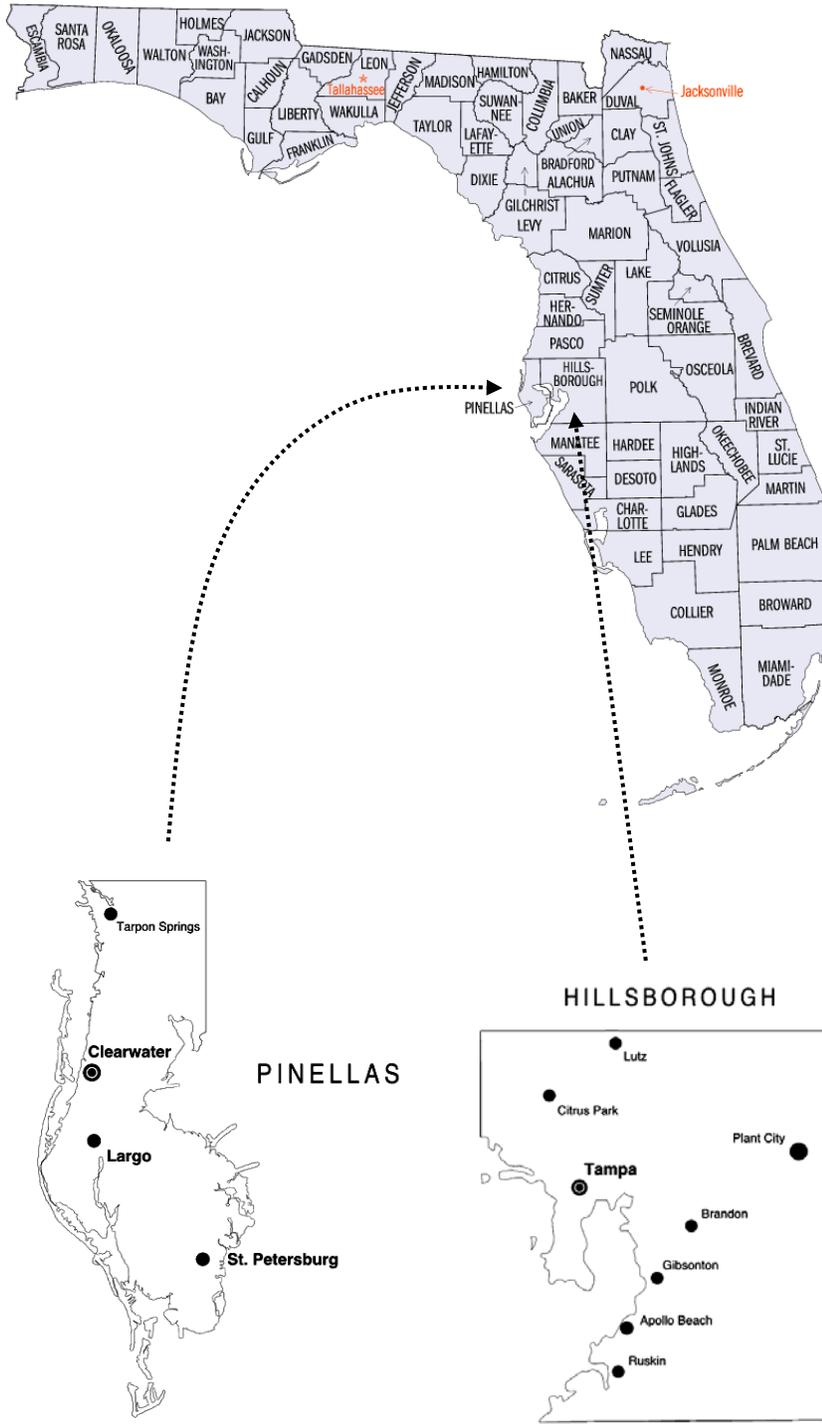
“Sinkhole Alley” Counties¹⁵



¹⁵ County maps from <http://fcit.usf.edu/florida/maps/countout/counties.htm>.

PRESUMED FACTOR

“Sinkhole Alley” Counties



PRESUMED FACTOR

APPENDIX C – OIR Market Share Reports¹⁶

Florida Office of Insurance Regulation Quarterly Supplemental Report--Market Share Report Top 10 Companies Ranked by Policies In Force

Quarter Ending Date: 12-31-2005

County: Pinellas

Data Source: QUASR Only

Rank	Company Name	Policies in Force	Policies in Force (%)	Exposure	Exposure (%)	Annualized Premium	Annualized Premium (%)
1	STATE FARM FLORIDA INSURANCE COMPANY	34,909	26.9%	\$11,837,402,125	32.4%	\$50,151,578	28.1%
2	CITIZENS PROPERTY INSURANCE CORPORATION	34,892	26.9%	\$7,799,716,826	21.3%	\$57,777,096	32.3%
3	NATIONWIDE INSURANCE COMPANY OF FLORIDA	16,334	12.6%	\$4,540,027,477	12.4%	\$15,740,311	8.8%
4	LIBERTY MUTUAL FIRE INSURANCE COMPANY	10,487	8.1%	\$4,171,023,950	11.4%	\$11,664,909	6.5%
5	ALLSTATE FLORIDIAN INSURANCE COMPANY	7,167	5.5%	\$908,289,482	2.5%	\$8,118,085	4.5%
6	TOWER HILL PREFERRED INSURANCE COMPANY	6,629	5.1%	\$1,698,690,487	4.6%	\$6,659,201	3.7%
7	FIRST FLORIDIAN AUTO AND HOME INSURANCE COMPANY	5,998	4.6%	\$1,639,776,745	4.5%	\$9,397,996	5.3%
8	FIRST HOME INSURANCE COMPANY	4,830	3.7%	\$1,027,395,104	2.8%	\$7,106,817	4.0%
9	UNITED SERVICES AUTOMOBILE ASSOCIATION	4,730	3.6%	\$2,073,082,260	5.7%	\$6,602,673	3.7%
10	AMERICAN STRATEGIC INSURANCE CORP.	3,654	2.8%	\$848,781,570	2.3%	\$5,409,404	3.0%
10	Totals For Selected County Set	129,630	100.0%	\$36,544,186,026	100.0%	\$178,628,070	100.0%

Policies Selected: Homeowners (Excl. Tenant and Condo)

The Office is validating the company submissions on the information provided herein, therefore the information is considered preliminary and subject to change.

Exposure is collected for those policies that include the peril of wind.

¹⁶ Provided by the Office of Insurance Regulation

PRESUMED FACTOR

Florida Office of Insurance Regulation Quarterly Supplemental Report--Market Share Report Top 10 Companies Ranked by Policies In Force

Quarter Ending Date: 12-31-2005

County: Pasco

Data Source: QUASR Only

Rank	Company Name	Policies in Force	Policies in Force (%)	Exposure	Exposure (%)	Annualized Premium	Annualized Premium (%)
1	CITIZENS PROPERTY INSURANCE CORPORATION	22,240	30.1%	\$3,587,743,448	20.4%	\$36,938,196	37.4%
2	STATE FARM FLORIDA INSURANCE COMPANY	21,361	28.9%	\$6,754,087,700	38.3%	\$33,894,284	34.4%
3	NATIONWIDE INSURANCE COMPANY OF FLORIDA	7,836	10.6%	\$1,710,762,849	9.7%	\$6,056,028	6.1%
4	ALLSTATE FLORIDIAN INSURANCE COMPANY	4,756	6.4%	\$501,507,336	2.8%	\$4,091,465	4.1%
5	LIBERTY MUTUAL FIRE INSURANCE COMPANY	4,597	6.2%	\$1,608,954,050	9.1%	\$4,615,558	4.7%
6	MERITPLAN INSURANCE COMPANY	4,070	5.5%	\$886,372,800	5.0%	\$4,023,549	4.1%
7	AMERICAN MERCURY INSURANCE COMPANY	2,613	3.5%	\$437,335,867	2.5%	\$2,851,230	2.9%
8	AMERICAN STRATEGIC INSURANCE CORP.	2,232	3.0%	\$661,201,932	3.8%	\$2,524,217	2.6%
9	HARTFORD INSURANCE COMPANY OF THE MIDWEST	2,161	2.9%	\$603,598,454	3.4%	\$1,794,256	1.8%
10	UNITED SERVICES AUTOMOBILE ASSOCIATION	2,113	2.9%	\$874,159,230	5.0%	\$1,858,705	1.9%
10	Totals For Selected County Set	73,979	100.0%	\$17,625,723,666	100.0%	\$98,647,488	100.0%

Policies Selected: Homeowners (Excl. Tenant and Condo)

The Office is validating the company submissions on the information provided herein, therefore the information is considered preliminary and subject to change.

Exposure is collected for those policies that include the peril of wind.

PRESUMED FACTOR

Florida Office of Insurance Regulation Quarterly Supplemental Report--Market Share Report Top 10 Companies Ranked by Policies In Force

Quarter Ending Date: 12-31-2005

County: Hillsborough

Data Source: QUASR Only

Rank	Company Name	Policies in Force	Policies in Force (%)	Exposure	Exposure (%)	Annualized Premium	Annualized Premium (%)
1	STATE FARM FLORIDA INSURANCE COMPANY	43,830	35.4%	\$16,907,131,303	38.2%	\$57,253,949	36.9%
2	NATIONWIDE INSURANCE COMPANY OF FLORIDA	12,932	10.5%	\$4,657,454,997	10.5%	\$14,512,386	9.4%
3	CITIZENS PROPERTY INSURANCE CORPORATION	12,399	10.0%	\$2,906,836,846	6.6%	\$17,983,134	11.6%
4	FIRST FLORIDIAN AUTO AND HOME INSURANCE COMPANY	10,979	8.9%	\$3,830,169,277	8.7%	\$15,068,727	9.7%
5	UNITED SERVICES AUTOMOBILE ASSOCIATION	10,049	8.1%	\$4,998,078,905	11.3%	\$10,095,734	6.5%
6	LIBERTY MUTUAL FIRE INSURANCE COMPANY	8,136	6.6%	\$3,456,630,750	7.8%	\$9,014,973	5.8%
7	GULFSTREAM PROPERTY AND CASUALTY INSURANCE COMPANY	8,026	6.5%	\$1,794,392,813	4.1%	\$10,956,632	7.1%
8	USAA CASUALTY INSURANCE COMPANY	6,339	5.1%	\$2,909,916,725	6.6%	\$8,012,404	5.2%
9	MERITPLAN INSURANCE COMPANY	5,637	4.6%	\$1,273,563,600	2.9%	\$5,600,952	3.6%
10	AMERICAN STRATEGIC INSURANCE CORP.	5,371	4.3%	\$1,488,702,100	3.4%	\$6,505,368	4.2%
10	Totals For Selected County Set	123,698	100.0%	\$44,222,877,316	100.0%	\$155,004,259	100.0%

Policies Selected: Homeowners (Excl. Tenant and Condo)

The Office is validating the company submissions on the information provided herein, therefore the information is considered preliminary and subject to change.

Exposure is collected for those policies that include the peril of wind.

PRESUMED FACTOR

Florida Office of Insurance Regulation Quarterly Supplemental Report--Market Share Report Top 10 Companies Ranked by Policies In Force

Quarter Ending Date: 12-31-2005

County: Hernando

Data Source: QUASR Only

Rank	Company Name	Policies in Force	Policies in Force (%)	Exposure	Exposure (%)	Annualized Premium	Annualized Premium (%)
1	STATE FARM FLORIDA INSURANCE COMPANY	13,515	40.7%	\$4,056,705,958	48.2%	\$16,004,876	43.1%
2	CITIZENS PROPERTY INSURANCE CORPORATION	7,504	22.6%	\$1,498,192,653	17.8%	\$10,518,141	28.3%
3	ALLSTATE FLORIDIAN INSURANCE COMPANY	3,074	9.2%	\$428,833,749	5.1%	\$2,489,875	6.7%
4	NATIONWIDE INSURANCE COMPANY OF FLORIDA	1,893	5.7%	\$509,715,070	6.1%	\$1,440,274	3.9%
5	LIBERTY MUTUAL FIRE INSURANCE COMPANY	1,597	4.8%	\$552,430,900	6.6%	\$1,655,984	4.5%
6	HARTFORD INSURANCE COMPANY OF THE MIDWEST	1,509	4.5%	\$466,227,748	5.5%	\$1,313,354	3.5%
7	ALLSTATE FLORIDIAN INDEMNITY COMPANY	1,475	4.4%	\$248,833,356	3.0%	\$1,098,314	3.0%
8	MERITPLAN INSURANCE COMPANY	911	2.7%	\$166,494,000	2.0%	\$739,834	2.0%
9	FLORIDA FARM BUREAU CASUALTY INSURANCE COMPANY	907	2.7%	\$268,920,163	3.2%	\$934,429	2.5%
10	AMERICAN STRATEGIC INSURANCE CORP.	848	2.6%	\$222,479,710	2.6%	\$955,821	2.6%
10	Totals For Selected County Set	33,233	100.0%	\$8,418,833,307	100.0%	\$37,150,902	100.0%

Policies Selected: Homeowners (Excl. Tenant and Condo)

The Office is validating the company submissions on the information provided herein, therefore the information is considered preliminary and subject to change.

Exposure is collected for those policies that include the peril of wind.