

Brattle's Rebuttal of The LECG Report

On the eve of the Congressional hearing on H.R. 3424, LECG released a 3-page report titled "The Neal Bill and the Florida Homeowners Multiple Peril Market" in an attempt to rebut The Brattle Group's analysis. The LECG report concludes that "there would be no financial effect of the Neal Bill on Florida Homeowners Multiple Peril," since "there is virtually no affiliate offshore reinsurance in the Florida Homeowners Multiple Peril market."

Brattle estimates that the insurance price for the Florida HMP coverage would increase between 1.0 and 4.2 percent. The 1.0 percent estimate is based on the Brattle's analysis of the nationwide insurance and reinsurance markets. As both LECG and Brattle recognize, applying the nationwide impact uniformly to each state is not sufficient, due to each state's own insurance and reinsurance market environment. However, because state-level reinsurance information for any particular line of insurance does not exist, Brattle develops a reasonable proxy to apportion 32 percent of the nationwide HMP reinsurance, including affiliate reinsurance, to Florida. As a result, Brattle estimates a 4.2 percent impact in Florida for the HMP line.

To the contrary, the LECG report claims that there is virtually no affiliate offshore reinsurance in the Florida HMP market. This is an incredible statement just on its face. First of all, it is grossly inconsistent with the 2005 hurricane trio claims payout experience, where foreign insurers and reinsurers provided 60 percent of the insured losses in the Gulf States. Between 2001 and 2008, offshore reinsurance for all lines of insurance increased from \$37.3 to \$58.2 billion, the proportion of affiliate offshore reinsurance increased from 43 to 57 percent of the total offshore reinsurance.¹ Since the United States depends critically on foreign reinsurance for the catastrophe risk coverage, LECG's claim of virtually zero use of affiliate offshore reinsurance for the Florida HMP coverage can simply not be true. Second, in 2009, the U.S. P&C insurers altogether ceded over 16 percent of their direct HMP premiums to reinsurers (\$11.2 billion out of \$67.5 billion), including 4 percent (\$2.4 billion) that was ceded by foreign-

¹ Joint Committee on Taxation, *Present Law and Analysis Relating to the Tax Treatment of Reinsurance Transactions Between Affiliated Entities* (JCX-35-10), July 12, 2010, at p. 11.

owned insurers to their offshore affiliates.² Since Florida is most heavily exposed to the hurricanes and other natural catastrophes,³ its demand for offshore reinsurance, both from affiliates and non-affiliates, should be disproportionately larger than the national average. To believe, as LECG suggested, that Florida used virtually none of the \$2.4 billion affiliate offshore reinsurance, one has to believe that (1) Florida HMP insurers only ceded reinsurance to non-affiliates for the HMP coverage; and (2) all other states, not as heavily exposed to hurricanes as Florida, purchased almost all of the \$2.4 billion affiliate offshore reinsurance. Both are unreasonable.

A closer look at the LECG's report reveals that LECG's claim of "virtually zero" use of affiliate offshore reinsurance in Florida is not supported by its own analysis. The "virtually zero" observation refers to the 0.3 percent calculated in Table 1 of the LECG report. However, it is based on the direct premiums written by the top 20 Florida HMP insurers, not just for Florida but for the country as a whole. In other words, the top 20 Florida HMP insurers wrote a total of \$36.9 billion HMP insurance nationwide, and ceded 0.3 percent of their nationwide HMP to offshore affiliates. As should be obvious to anyone (including LECG, Mr. William Berkeley and the other proponents of H.R. 3424), the coastal catastrophe-prone markets such as Florida bear little resemblance to the national market for HMP!

Additionally, simple inferences, like LECG's comparison of direct premiums written with the use of affiliate offshore reinsurance, can be unreliable and inconsistent with market practices. For example, U.S.-based insurers often obtain non-affiliate reinsurance from U.S. subsidiaries of large foreign insurance groups, which in turn cede the premiums to their offshore affiliates through affiliate offshore reinsurance. In this instance, inference based on direct premiums underestimates the true risk transfer through affiliate offshore reinsurance. If H.R. 3424 were to pass, it would adversely affect that reinsurance capacity, thereby reducing non-affiliate reinsurance support for the U.S. insurers.

² Tables 3 and 4 of the Brattle report.

³ RMS, a nationally recognized authority on catastrophe risk-modeling, estimates that Florida accounts for 56 percent of nationwide hurricane tail risks (risk of losses that occurs only once every 100 or 250 years).

Finally, it should be pointed out that consumers and businesses alike in Florida and other hurricane-prone states need property lines of insurance more than just HMP. Since these other lines — such as commercial multiple peril, and allied lines — have similar catastrophic exposure to HMP, the substitution from affiliate reinsurance to non-affiliate reinsurance would crowd out the reinsurance capacity for Florida HMP line. Brattle's analysis does not consider the interaction of these related insurance lines.