AFFILIATED FEE ANALYSIS EXECUTIVE SUMMARY

****INFORMATION CONTAINED HEREIN IS CONSIDERED CONFIDENTIAL AND/OR TRADE SECRET PURSUANT TO SECTIONS 624.4212 AND 624.4213, FLORIDA STATUTES****

TO: Virginia Christy
Director, Property and Casualty Financial Oversight

FROM: Jan Moenck

DATE: March 31, 2022

SUBJECT: Affiliated Fee Analysis Executive Summary

I. Background

The Florida Office of Insurance Regulation ("FLOIR" or "the Office") engaged Risk & Regulatory Consulting, LLC to complete an analysis of fees paid to Florida domestic property insurer affiliates. This analysis was completed in a series of four (4) phases. Individual reports for each phase are included as **Appendixes** to this summary. The analysis considered a three-year period (2017-2019) in order to avoid an unusual result based on the results of a single year. The initial phase was conducted before the insurers' 2020 Annual Statements were required to be filed with FLOIR, and subsequent phases used the same time period for comparative purposes.

In total, fifty-seven (57) companies, either individually or as a part of a group of insurers, were selected for review. Four (4) of the companies selected were not reviewed due to due to recent acquisition transactions and/or insufficient data (the insusurer began operations in 2019). Three (3) of the remaining fifty-three (53) companies were liquidated in 2021 or 2022. Forty-one (41) of the fifty-three (53) companies utilize a Managing General Agent (MGA) or Attorney-in-Fact (AIF) to administer policy and claim operations.

While Florida does not have specific statutory guidance defining "fair and reasonable" for the purpose of affiliated agreements and transactions, we considered the following guidance in evaluting the affiliated fees and transactions:

- Administrative Rule 69O-143.047, Florida Administrative Code, which sets certain standards regarding material transactions between an insurer and its affiliates.

- Administrative Rule 69O-143.047, Florida Administrative Code, which requires that all management agreements, service contracts, tax allocation agreements, cost-sharing arrangements and any material transactions which the Office determines may adversely affect the interests of the insurer's policyholders be submitted to the Office for review.
- The National Association of Insurance Commissioners Statutory Statement of Accounting Principles, No. 25 Affiliates and Other Related Parties.
- Guidance regarding the "fair and reasonable" standard in the NAIC *Financial Analysis Handbook*.

The individual reports contained as **Appendixes** contain more detail in terms of specific considerations made in evaluating whether agreements and transactions were considered "fair and reasonable".

II. Summary

While some insurers doing business in Florida perform most or all of the functions necessary for the operation of an insurance company utilizing their own employees, a significant number of insurers contract one or more of the those functions to affiliated entities or to a third party. The contracted functions may incude any of the following: accounting, actuarial, management of investments, information technology administration, policy issuance and administration, underwriting, reinsurance intermediary services, claims investigation and settlement.

Florida domestic insurers have used a variety of methods of determining compensation for affiliated and non-affiliated agreements including the following:

- Percentage of written premium;
- Percentage of earned premium;
- Precentage of written or earned based on losses incurred;
- Hourly rate of compensation based on specific tasks;
- Yearly or quarterly fee payment schedules;
- Scheduled bonus payments;
- Commissions;
- Commissions based on multiple criteria;
- Any combination of one or more of the methods listed above, and in some cases, a forgiveness of fees due under the terms of an agreement.

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The list above is not exhaustive of all compensation arrangements. In considering whether the fees paid by an insurer are in fact “fair and reasonable” it would be logical to focus on the types of services provided to an insurer in order to compare the fees paid. However, in many cases an affiliate may provide multiple types of services with only a single contractual method to compute compensation. Insurers that contract with affiliates for services typically have an agreement directly with an affiliate. However, a number of affiliates further subcontract the services to other affiliates of the insurer adding further complexity to understanding whether the compensation for the services is “fair and reasonable”. Further complicating an understanding of the reasonableness of fees paid to affiliates, is the practice of some affiliates of “forgiving” or “waiving” fees due from an insurer.

In order to form a basis for comparison, the following elements, common to all insurers in the sample were utilized:

- The amount of gross written premiums
- The total amount of fees paid to affiliates
- The percentage of fees paid to affiliates of gross written premiums
- The number of policies in force at the end of each calendar year
- The net income of the insurers
- The net income of affiliates
- Capital contributions
- Forgiveness or waiver of fees owed to affiliates
- Dividends

The analysis was performed at a high level utilizing financial statements and other related documents on file with or requested by the Office. Some of the insurers reviewed in this analysis had agreements in place with affiliates that provided for fees based on an allocation of actual costs.

In addition to considering the above elements, we also analyzed the underwriting and loss expenses reported in the annual statements for all years under review. The results of that analysis were consistent with the above and further support the conclusion for the insurers with fees determined to be “not fair and reasonable”.

A number of the documents utilized were filed with the Office by an insurer as a “Trade Secret”. As such, information regarding any of the individual companies discussed in the Appendixes to this report may not be released without approval of the Director.

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III. Conclusions

The chart below provides a summary for the fifty-three (53) insurers reviewed.

Those insurers reported a total of approximately $61 million in net income over the 2017-2019 time period. Insurer net income is skewed by an outlier insurer's $493 million net income. Without that one insurer the aggregate net loss for the insurers reviewed would have been $(432) million. The affiliates providing services to those insurers recorded approximately $14 billion in net income. Similarly, there were two outliers in affiliated provider category and the total net income would have been reduced to $1.8 billion if two national insurers were excluded.

Financial information for some affiliates that provided services to the insurers in the sample was not available or provided at the time this analysis was conducted. As a result, the net income of the affiliates may be understated. In some cases, the net income of an affiliate included debt service expense for capital contributions that were provided to an insurer.

Totals All Sample Insurance Company / Affiliates	Insurance Company Net Income				Affiliates Net Income			
	2017	2018	2019	Total	2017	2018	2019	Total
All Sample Companies	25,021,077	(37,092,793)	73,928,507	61,856,791				
All Sample Companies Affiliates					3,313,724,022	7,394,482,911	4,062,630,038	14,770,836,971
All Capital Contributions / Fee Forgiveness / Surplus Notes	355,458,673	446,913,976	357,808,134	1,160,180,783				
All Dividends	193,743,000	215,539,268	270,678,898	679,961,166				
Surplus Note Payments to Parent / Affiliates	*(1,360,000)*	*(10,360,000)*	*(36,360,000)*	*(48,080,000)*				

The information available also shows that affiliates of the insurers in the sample waived fees due under affiliated agreements in the amount of $208 million, made capital contributions in the amount of approximately $951 million. During the 2017-2019 time period, $680 million in dividends were paid by insurers and $48 million was paid on surplus notes, which reduced the capital of twenty-nine (29) insurers by a total of $728 million. The financial results, including the need for capital contributions or the forgiveness of fees, differed significantly among insurers.

Overall, the analysis results can be broken down into two general categories; 1) Thirty-five (35) single state / regional insurers; and 2) Eighteen (18) insurers which are members of, or have an affiliation with, a national service or insurance group. These two categories can be further broken down into "fair and reasonable" and "not-fair and reasonable" fee structures. Nineteen (19) of the single state / regional insurer fees were deemed "not-fair and reasonable" and five (5) others underdetermined based on complete information not being provided. Only one (1) of the national insurer fees were deemed "not-fair and reasonable" and eleven (11) others underdetermined based on complete information not being provided.

The majority of the single state / regional insurers appear to use MGAs as a revenue stream for the holding company based on the positive net income of the holding company despite $208 million in fee forgiveness and $485 in capital contributions during the review period. The national companies use a combination of MGAs and affiliated cost sharing agreements to administer operations with no fee forgiveness and $156 million in capital contributions. Compensation for all MGA agreements reviewed ranged from 20% to 34% of premium. Total affiliated fees, including MGA, claims, commissions, and investment management, ranged from less than 1% to 63% of premium.

IV. Recommendations

Based on the review performed and general observations, recommendations relating to the Companies reviewed are as follows:

1) The Analyst should update the analysis to include information from the 2020 and 2021 Annual Statements and determine if any additional trends or concerns are noted, or if regulatory action is required. The analysis should then be maintained and updated at least annually.

2) A number of MGA agreements are ten (10) or more years old and do not contain adequate language to address data security, access, ownership, and control, especially in the event of regulatory proceedings. The Office should consider requiring all MGA agreements be reviewed and updated as needed to address data provisions.

3) A number of MGA agreements are ten (10) or more years old and have premium based compensation parameters exceeding 25%. The Office should consider requiring insurers to review, amend or replace affiliated MGA and other agreements and / or provide documentation and financial projections that demonstrate that the proposed fees in the agreements are fair and reasonable to the insurer.

4) Ten (10) companies reviewed had $208 million in MGA fees forgiven and received $60 million in capital contributions during the three-year period. MGA profit, after fee forgiveness, was $130 million during the same three-year period. While the MGA model is common in Florida to attract capital, MGA fee structures could be used to circumvent insurer dividend requirements. The Office should consider requiring insurers to review, amend or replace affiliated MGA and other agreements and / or provide documentation and financial projections or other corrective measures that demonstrate that the proposed fees in the agreements are fair and reasonable.

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5) Several insurers failed to provide complete information needed to fully assess the reasonableness of MGA and other affiliated agreements. The Office should consider obtaining the missing information or conducting limited scope examinations to review the reporting of insurers, transactions with affiliates, and expenses associated with payments to those affiliates.

6) It was difficult to follow amounts paid to affiliates in the Schedule Y Part 2 of several of the insurers which were part of a holding company group with affiliates domiciled in other states. It is recommended that these intercompany transactions be reviewed in conjunction with the next coordinated financial examination so all affiliates can be reviewed at the same time to better understand the flow of funds between affiliates.

7) Ten (10) insurers received $208 million in debt forgiveness and twenty-eight (28) received capital contributions totaling $951 million during the three-year period under review. Several of these infusions were done to replenish lost capital and prevent regulatory intervention. Given the reliance on infusions, the Office should consider whether the provisions of Rule 69O-141.002(2)(q), Florida Administrative Code regarding criteria for determining unsound condition, or which render the continuance of business hazardous to the public or insureds, should be applied to insurers with these financial results.

8) During the review, several inconsistencies were identified between the amounts reported as expenses paid to affiliates on the companies Underwriting and Investment Exhibit page 11, Notes to Financial Statements Note 10.B., Schedule Y Part 2, and audit reports. Additionally, some related parties were not listed on Schedule Y Part 1 as an affiliate. If the analyst finds material inconsistencies in the review of the 2021 Annual Statements, the Office should consider requesting companies provide explanations for the inconsistencies and/or to resolve an inaccurate reporting. This should be expanded to be part of the overall analysis review of all companies going forward.

9) Based on the operational results of two (2) companies and their affiliates, the Office should consider meeting with the Company to discuss the long-term viability of the current business plan and potentially require a new business plan. The Office may also wish to consider enhanced monitoring of the companies.

Additional Recommendations, not specific to the companies reviewed, include:

1) Amendments to Sections 627.7451 and 626.7452, Florida Statutes, effective July 2022 removed certain contractual and examination exclusions for affialted MGAs. Based on this change, the Office should consider requiring all MGA agreements be filed or refiled for review and approval concurrently with the effective date of the amendments.

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2) Amendments to Section 627.7452, Florida Statutes provide that an MGA may be examined as if it were the insurer even if the MGA solely represents a single domestic insurer. For those companies with significant MGA fees, the Office should consider including the MGA in the scope of the next financial examination of the insurer.

3) Amendments to Section 624.424, Florida Statutes expands the Office's ability to obtain "any information the office deems necessary" regarding affiliated fee transactions. For those companies with significant MGA fees, the Office should consider utilizing this statutory authority to obtain information certain insurers previously declined to provide and / or including the MGA in the scope of the next financial examination of the insurer.

4) In conjunction with changes being made to the Insurance Holding Company Model Act and Regulation, when reviewing new or amended agreements, the Office should ensure the agreements address the following provisions, among others:

- All records and data of the insurer held by an affiliate are and remain the property of the insurer, are subject to control of the insurer, are identifiable, and are segregated or readily capable of segregation, at no additional cost to the insurer, from all other persons' records and data.

- At the request of the insurer, the affiliate shall provide that the receiver can obtain a complete set of all records of any type that pertain to the insurer's business; obtain access to the operating systems on which the data is maintained; obtain the software that runs those systems either through assumption of licensing agreements or otherwise; and restrict the use of the data by the affiliate if it is not operating the insurer's business.

- Ownership and timely access to assets and records held by an MGA should be explicitly set forth in contract, and shall not conflict with Chapter 631 Part 1, Florida Statutes.

Attachments

Phase 1 Report

Phase 2 Report

Phase 3 Report

Phase 4 Report

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