October 12, 2021

State of Washington Office of the Insurance Commissioner
302 Sid Snyder Ave., SW
Olympia, WA 98504
Attention: David Forte

Sent via email to: rulescoordinator@oic.wa.gov.

RE: Proposed Regulation Prohibiting the Depreciation of Labor on Property Claims (R 2021-04) – Trades' Additional Written Comments

Dear Commissioner Kreidler:

On behalf of the National Association of Mutual Insurance Companies (NAMIC), the American Property Casualty Insurance Association (APCIA), and the NW Insurance Council (NWIC), we would like to share our concerns with you about the above captioned proposed regulation.

As we stated in our July 2021 written comments to the draft proposed regulation, the trades are concerned that the proposed regulation would adversely impact consumers who want the opportunity to purchase an Actual Cash Value (ACV) coverage policy that is discounted in price to reflect the rational depreciation of the value of the insurance claim for labor costs. The trades are also concerned that the proposed regulation is inconsistent with the long-established legal doctrine of "contractual depreciation" and is an inappropriate regulatory overreach into the contractual relationship between insurers and their policyholders.

The trades respectfully submit the following comments for consideration:

1) **The proposed regulation exceeds the regulatory authority of the Office of the Insurance Commissioner (OIC)**

   The trades are concerned that the proposed regulation would effectuate a fundamental change in current state law on the contractual rights and responsibilities of insurers and consumers as agreed to by the parties in the insuring agreement. Any proposed change to statutory law should be accomplished via the legislative process, not by way of regulatory overreach into the legislative function. Furthermore, any disagreement over the legality of a provision in an insuring agreement should be left to the authority of the judicial branch of government.

   The proposed regulation fails to cite any specific regulatory authority for the OIC to change current state law which allows insurers to contractually define "depreciation and betterment" in their insuring agreement. Additionally, the OIC has failed to cite any regulatory authority to deny

insurance consumers of their right to purchase an Actual Cash Value (ACV) insuring agreement priced to reflect "depreciation of labor or betterment".

The OIC has also failed to cite any enabling legislation that authorizes the department to redefine what "contractual depreciation" means and how it shall be applied to the insurance policy. Further, there is no statute or case law on point to support the OIC's position that "contractual depreciation" may not legally include "the expense of labor necessary to repair, rebuild or replace covered property…" The OIC lacks authority to rewrite well-established contract law and impose its own interpretation on insurers and policyholders, in this case to the detriment of the marketplace and certain insurance premium-cost sensitive consumers.

Moreover, the trades believe that the OIC's legal position is inconsistent with case law and will lead to legal uncertainty for consumers. Washington courts have long upheld the right for competent parties to reach agreement on the contractual terms governing their relationship. Simply put, "[u]nless [a] contract is illegal or violates public policy, the court will not interfere in the agreement of competent parties." *Redford v. City of Seattle*, 615 P.2d 1285, 1289 (Wash. 1980). The OIC has not identified any basis for treating the longstanding industry practice of labor depreciation – which many state and federal courts, as well as state legislatures, recognize as valid – as illegal or contrary to public policy. To the extent such a determination is made, it should come from the Washington Legislature—not the OIC.

Significantly, the approach contemplated by the draft proposed regulation has been squarely rejected by a strong majority of state supreme courts that have addressed the issue, including the supreme courts of Oklahoma, Nebraska, Minnesota and North Carolina. As the North Carolina Supreme Court explained in its February 2020 decision in Thomas Accardi v. Hartford Underwriters Insurance Company, "[t]he policy language provides no justification for differentiating between labor and materials when calculating depreciation, and to do so makes little sense. The value of a house is determined by considering it as a fully assembled whole, not as the simple sum of its material components."

The trades believe that the OIC needs to demonstrate that: a) it has the *regulatory authority* to interfere with the contractual rights of insurers and policyholders to enter into a lawful contractual depreciation relationship; b) the proposed regulation *is necessary* to remedy a current specific problem in the insurance marketplace; and c) the proposed regulation is *in the best interest* of insurance consumers.

2) The proposed regulation could adversely impact affordability of insurance, and discourage consumers from repairing damaged property, i.e. being good personal risk managers.

In addition to fundamentally altering the contractual rights and responsibilities of insurers and policyholders, the draft proposed regulation will also force insurers to recalculate the cost of ACV insurance products to make sure that their rates are actuarially sound in light of the new coverage requirements imposed by the regulations. Additionally, the draft proposed regulation will create new and unnecessary administrative costs for insurers, which will ultimately act as an insurance rate cost-driver for consumers.

Current insurance rates are partially based upon the fact that "contractual depreciation" may be applied to the covered property and related labor costs associated with the insurance claim. It is hard to imagine how this regulatory mandate would not increase the cost of insurance coverage for consumers. The draft proposed regulation would also create claims adjusting problems for

insurers who use computer estimating software that calculates labor costs and property material costs together.

Additionally, the trades are concerned that the draft proposed regulation will discourage consumers from being good personal risk managers who fully repair their damaged property. "Contractual depreciation" provisions provide consumers with an economic incentive to *actually* repair the damaged property, so as to minimize the consumer's risk of loss exposure and prevent future property damage that may not be included in insurance coverage. The draft proposed regulation is more likely to harm consumers, rather than helping them, because it will allow consumers to "pocket" labor costs that should be used to repair the damaged property.

We noted with interest the Commissioner's blog post regarding the proposed rulemaking, which included this telling, but inaccurate statement:

"If your policy allows the insurer to depreciate labor costs and you have a claim, the contractor you work with may require you to pay labor costs up front. Otherwise, the contractor is forced to float the cost of paying its employees until all repairs are complete. That can mean a large output of cash for policyholders that they won't get back until months later. Insurers routinely – often with the support of insurance regulators as well as agencies that regulate the residential construction industry – remind consumers that they should never pay repair costs "up front," prior to the satisfactory conclusion of any repair project, and we encourage claimants to work with their insurance agent or company to make sure repairs are completed as promised, in a quality fashion, prior to paying in full for any repairs."

Insurers routinely – often with the support of insurance regulators as well as agencies that regulate the residential construction industry – seek to prevent fraud by recommending that no consumer should pay any repair costs "up front," prior to the satisfactory conclusion of any repair project, and they encourage claimants to work with their insurance agent or contractor to make sure repairs are completed as promised, in a quality fashion, prior to paying in full for any repairs. Reputable contractors never demand full payment upfront. But they do need some funds to start securing permits and purchasing materials, which is what the ACV payment provides. Once the repairs are completed, a final invoice is issued. When the insured is satisfied, the difference between the ACV payments, including any additional advances and the final cost of the repairs, is made up to the policy's limits.

We find that this reasoning - that an insured might be "out of pocket" for a lengthy time period because they were forced by a contractor to "pay up front for labor costs" - to be unlikely at best, and we would encourage the OIC to support insurer efforts to fight contractor fraud as an alternative to exceeding statutory authority to interfere in insurance contracts in a way that is likely to increase the cost and decrease the availability of affordable ACV-based property policies for Washington consumers.

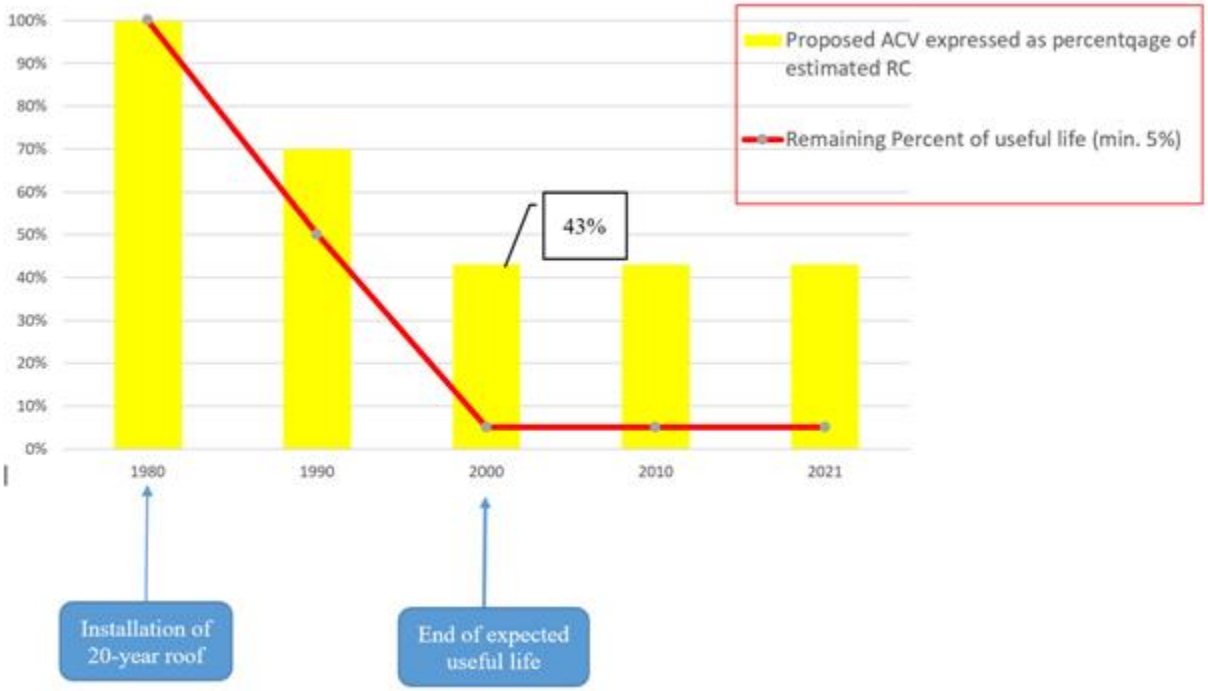
3) **The proposed regulation is based upon inaccurate underwriting assumptions, which could adversely impact insurers' ability to provide consumers with rates that properly reflect risk of loss exposure.**

The distinction between "restorative" and "embedded" labor is a false distinction. Insurers are not depreciating the labor (current or past). Rather, insurers are reducing the overall RCV to reflect the benefit the insured had already received prior to the loss. An insurer who enjoys the benefit of a 20-year roof for 15 years before sustaining hail damage has not been deprived of 5

years of materials and 20 years of labor. The insured has lost only one roof, and that roof could have reasonably been expected to provide only 5 more years of use before requiring replacement anyway (25% of the economic expectation). To provide more than 25% of the estimated repair cost (representing the insured's actual lost use) would result in a windfall.

The OIC's proposed rule effectively requires insurers to pay a minimum ACV amount: 100% of estimated labor costs in today's dollars, plus a portion of the estimated material costs. Put plainly, under the proposed rule, the ACV payment could *never* be less than the cost, in today's dollars, of paying for the labor involved in the repair, no matter how old the structure was or how bad its condition. The following example demonstrates the inequity of the proposed rule.

a. In 1980, the insured has a new 20-year roof installed on his existing home. Assume that, at that time, the ratio of materials to labor for roofing is 60% materials and 40% labor, and that the ratio (materials to labor) stays roughly the same throughout the next 40 years. The red line in the graph below shows how the roof's value diminishes over time as it wears out and nears or even far exceeds its expected 20-year useful life. The yellow bars show that, under the proposed rule, the insured will never receive less than 43% of the estimated repair costs. This is illogical. No insured would reasonably expect to receive the same amount (or likely more) in labor costs to repair a 40-year-old roof that lasted twice as long as expected than he would receive in estimated labor costs to repair a brand new roof. Yet that is exactly what the proposed rule would require, and this would continue even if the insured decided not to replace the roof for 50, 60, or 70 years.



The trades are also concerned that the OIC's understanding of the concept of "labor" is misplaced and its definition of "labor" is artificially narrow. "Labor" is a resource inextricably embedded in all materials created, just as labor is a resource necessary to install the materials in a final

project. Creating an artificial distinction in depreciating the labor based upon *where* the labor resource occurs (in a factory – depreciation allowed by regulation vs. on-site at the home – depreciation not allowed by regulation) makes no sense. This is especially true when you think about, for example: materials like gutters that can be purchased pre-made or created on site at the time of repair.

The distinction between labor and materials is not recognized in appraisal or tax contexts. In both, depreciation is applied to *all* costs, not just the materials component. Carriers' existing practice is already more favorable to consumers because the depreciation factor is applied to the higher replacement cost in today's dollars rather than the actual initial cost to build the home or repair/rebuild the damaged portion.

As common experience has taught us all, anyone who has ever bought or sold a used car knows that the "labor doesn't depreciate" argument is a complete fiction. No one would argue that a car's value will always be equal to or greater than the labor costs to repair or replace it at the time of an accident. The argument is just as illogical with a home's roof or flooring. The lost value to the insured is not the loss of shingles or wood planks and long-ago expended labor. The loss is of the actual roof or floor and, when compensating for that loss, the ACV payment should be reflective of all the years during which the insured already enjoyed the use of the roof or floor, and how many years the insured actually lost in future enjoyment of the wood or floor by reason of the loss.

The new ACV methodology that will result from the regulation could increase ACV claims payment amounts and ultimately be an insurance rate cost-driver that could adversely impact affordability of ACV-only policies and endorsements sought by certain consumers. The trades believe that the OIC should avoid adopting a proposed rule that conflates RCV policy benefits with ACV policy benefits. The existing RCV vs. ACV framework allows consumers to make meaningful choices between ACV policies/endorsements (allowing them to pay a much lower premium in recognition of the fact that the home, roof, or floor routinely needs to be repaired or replaced as part of standard asset preservation maintenance) and RCV policies/endorsements (which require a higher premium and accordingly afford a larger benefit).

In closing, the trades respectfully request that the OIC withdraw the draft proposed regulation and work with insurers, on a case-by-case basis, to address any specific concerns the department has with current claims adjusting practices as they relate to "contractual depreciation". A blanket prohibition against the depreciation of labor will create unnecessary financial burdens for policyholders without creating any appreciable benefit to insurance consumers.

Thank you for your consideration.

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