Market Study of Insurance for Affordable Housing Providers in Washington State:

Availability and Affordability of Property and Liability Insurance for Housing Providers Receiving Housing Trust Fund Resources Under RCW 43.185A.130 and Serving Extremely Low-Income Households as defined in RCW 36.70A.030

Presentation to Work Group Members Prepared at the Request of the Washington State Office of the Insurance Commissioner

Prepared by Davies Actuarial, Audit & Consulting, Inc. with support from Alvarez & Marsal Financial Services Industry Group, LLC

October 23, 2024

Davies

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Introduction to the Presenters (or "Authors")

The Washington Office of Insurance Commissioner ("OIC") Retained Davies Actuarial, Audit & Consulting, Inc. ("Davies") to conduct this market study. Alvarez & Marsal Financial Services Industry Group, LLC ("A&M") assisted Davies on the project.

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Presentation Structure and Estimated Timing

Executive Summary	30 mins
Genesis and Purpose of Market Study	
Insurance Challenges for Housing Providers	
The Authors’ Approach to Study the Problem	
Concepts in Insurance	
Findings: Housing Providers’ Insurance Challenges	
Policy Options Summary	
Policy Options	60 mins
Q&A	30 mins

Executive Summary

Genesis and Purpose of this Market Study

Affordable housing providers receiving Housing Trust Fund resources ("**Housing Providers**") **serve a critical role** in meeting the housing needs of extremely low-income households, including chronically homeless people who require permanent supportive housing ("PSH")

Housing Providers have recently reported serious **challenges in securing property and liability insurance** coverage at affordable rates

The OIC retained the Authors to **identify underlying causes and suggest policy options**

This report describes **12 policy options** that have the potential to improve the availability and affordability of insurance for Housing Providers

Insurance Challenges for Housing Providers

- Insurance carriers **declining to renew** a specific policy or leaving the market altogether
- Annual **premium increases** that Housing Providers cannot afford given their limited budgets
- **Decreasing insurance coverage** in the form of higher deductibles or lower limits or sub-limits
  - A **higher deductible**[1] means that the Housing Provider retains more risk in the event of a loss. Deductibles are increasing either because insurers want to limit their risk or because that is the only way the Housing Provider can afford to pay the premiums
  - A **lower limit** reduces the maximum amount the carrier will pay (gross of the deductible) for losses on the insurance policy. A sublimit applies to a specific type of loss
- Housing Providers are **paying claims from their operating budgets** rather than submitting claims to their insurers, to reduce the risk of future premium rate increases

[1] The "deductible" is the portion of a claim that the insured must pay before the carrier pays any claim.

The Authors' Approach

Gathered Information

- Conducted numerous **interviews** with market participants to understand the issues, challenges and potential policy options[1]
- Gathered data from Housing Providers through a voluntary **survey**
- Gathered Housing Providers' insurance experience (including premiums and claims) through a **data call** issued by the OIC
- Conducted market **research** to understand the broader market conditions

Synthesized and Analyzed

- Conducted **actuarial analysis** to understand the extent to which underlying claim costs are driving the insurance availability and affordability challenges
- **Evaluated options** based on their expected impact on availability and affordability of insurance, implementation costs, time required to implement, risks and mitigants, and dependencies for success on other actions or conditions
- Considered each option's expected impact on the "**total cost of risk**"
  - Total cost of risk is the total cost of property and liability claims, rather than only the cost of insurance.
  - Reducing and stabilizing TCOR is the best way to reduce the cost of insurance over the long term

[1] Market participants include Housing Providers, insurers, insurance brokers, regulators, and legislators.

Concepts in Insurance: Policy Terms and Types

We will use the following terms throughout this presentation

- An insurance policy does not reduce risk – it **transfers risk** from the policyholder to the insurer
- The policyholder pays a **premium** to the insurer to accept the risk
- If the policyholder suffers financial harm from a covered event, they file a **claim** with the insurer
- Claims that result in payments by the insurer are referred to as **losses**
- The insurer deducts the amount of the **deductible** (if any) from the amount that it pays

Housing Providers purchase two primary types of insurance

- **Property insurance**, which covers physical damage to a property
- **Liability insurance**, which covers risks such as an injury to a resident resulting from a broken handrail

Concepts in Insurance: Calculating Premium Rates

Per the Casualty Actuarial Society's ratemaking principles, insurance premiums should be based on actuarial estimates of **all future costs** of providing the insurance **for each risk individually**.

Costs to consider when setting premium rates:

- **Losses:** The largest component of cost is typically the estimated covered losses.
  - **Trends:** When using past losses to predict the future, adjust them to reflect current costs (e.g. construction cost inflation) and exposures.
  - **Catastrophes:** Insurers should estimate expected losses from hurricanes, earthquakes, tornados, wildfires and other catastrophes. Insurers often use "catastrophe models" to estimate these losses.
- **Operating Expenses:** The insurer estimates all the operating expenses it will incur to issue and manage the policy – such as commissions paid to insurance brokers, employees' salaries, fees paid to independent insurance adjusters and law firms, and so on.
- **Reinsurance:** Insurers transfer a portion of the premium and risk to reinsurers as a necessary tool to protect their capital and ultimate solvency. The net cost of this reinsurance should be considered in the rate.
- **Cost of Capital:** Regulators require insurers to hold a minimum amount of capital as "cushion" to protect policyholders. Investors must earn a sufficient return on that invested capital to justify investing it in the insurer instead of in some other industry.
- **Profit Margin:** Insurers add a reasonable profit margin to their costs when setting premium rates.

An insurance policy's price must be set before its cost is known

Concepts in Insurance: Availability and Affordability

Insurance prices and availability are based on historical claims and estimates of future trends

- Most insurers are for-profit businesses that are regulated to ensure they remain solvent to pay their claims
- They must set rates that are reasonable and are not excessive, inadequate, or unfairly discriminatory
- When insurers cannot accurately predict their costs or set rates that they expect to be profitable, they may exit the market segment, causing availability issues

Long-term methods to address insurance availability and affordability issues include:

- Modify the exposure to reduce expected losses – e.g. by making a building stronger
- Modify the insurance coverage to reduce expected losses – e.g. by reducing the coverage limit for a property's contents
- Modify the environment – e.g. by changing laws to reduce the likelihood of lawsuits or limiting damages
- Reduce the insurer's expenses, such as operating costs or the cost of reinsurance
- Combinations of the above

If the commercial insurance market cannot provide affordable insurance for a market, the government may choose to create a program to insure the risk

- Solves the availability problem and may address affordability, depending on its structure
- Requires initial capital and, if its insured losses and expenses are higher than its premiums, ongoing funding

Concepts in Insurance: Insurance Regulation

Generally speaking, insurance regulation is carried out at the state government level, and not the federal government level

- The primary regulator of insurance companies in Washington is the Office of the Insurance Commissioner (OIC)
- The regulators have many roles in protecting Washington consumers, including ensuring the insurance rates are reasonable, customers are treated fairly, and insurance companies maintain solvency.

Standard (admitted) insurance companies are required to file their rates with the OIC. This has several benefits to Washington consumers, including:

- It allows the OIC to determine if the insurance rates are excessive, inadequate, or unfairly discriminatory.
- Generally, insurance companies are allowed to discriminate between risks (i.e. charge higher rates for risks believed to have a higher expected cost), as long as they have sufficient data and information to support the rate differentials. Unfair discrimination, in which the insurance company cannot support the rate differentials, or which violate public policy for some other reason, is not allowed.
- It includes documentation of how rates are calculated for any given insured, providing transparency into the insurance rating process.

Insurance companies in this space are not generally required to file their rates. The insurance companies are largely either risk pools or excess & surplus (E&S) insurance companies:

- Risk pools are not regulated by the OIC
- E&S insurance companies are, by law, not required to file their rates with state regulators.

Findings: Causes of Housing Providers' Insurance Challenges

Macro Conditions

- Property Casualty insurance prices have increased throughout the industry due to inflation in the cost of repairs, extreme weather events, and higher reinsurance costs which cover large and unique events
- This is known as a "hard market" for insurance

Types of Properties

- Many Housing Provider locations are outside the parameters that insurers consider to be attractive risks. These include:
  - **Old properties** with wood frame construction, old roofs, and lacking the typical safety measures found in modern buildings, and
  - New properties that have **appraised values higher than $10M**, which is above the limit that many carriers will accept for a single risk

Profile of the Residents

- Insurance carriers perceive increased risk associated with the extremely low-income and PSH sub-sectors of the affordable housing market because complexity of residents may drive behaviors that result in higher insurance claims.

Findings: Actuarial Analysis of Data

We performed an actuarial analysis of the data provided in the Data Call. We concluded:

- Based on this analysis, the Authors see no evidence that current insurance rates in this segment are excessive, from an actuarial point of view.
- The Authors estimate that the total annual insurable losses in this segment for all units within scope combined is between $10.8 million - $14.0 million. This includes both costs paid by insurers and costs retained by Housing Providers
- The above is based on an estimate of total cost per unit of between $1,500 to $1,950, for units within scope.

Difficulties in analyzing data:

- The authors were not able to receive complete data for all insurers or housing providers. This is due to both timing and data limitations.
- Insurance companies do not issue policies specific to extremely low-income units or PSH units. Policies are issued on a combined basis to Housing Providers, which usually cover multiple different types of affordable housing, often within the same building.
- Since the primary source of data for the actuarial analysis was the Data Call issued to insurance companies, no data was provided on losses retained by the Housing Providers.
- This is a relatively small market, leading to a large degree of volatility in the data.

Policy Option Categories

The individual policy options recommended for consideration can be grouped into three broad categories, and a fourth broad category that includes combinations of the first three:

Reduce the total cost of risk ("TCOR") by physically improving properties, increasing property inspections or mitigating behavioral risks

- Over time, should reduce insurance claims and lead to increased availability and lower premiums
- Unlikely to materially impact availability and price in the near term because it will take time for the improvements to be implemented

Increase availability of insurance by establishing a new (re)insurance mechanism capitalized with public funds ("Public (Re)insurer")

- Does not reduce total cost of risk
- May reduce insurance premium costs if
  - (1) private (re)insurers are over-pricing the risk (which we have not seen evidence of),
  - (2) the government provides the Public (Re)Insurer with ongoing funding so that it can charge rates that are less than actuarially sound, or
  - (3) the Public (Re)insurer can operate with lower costs and profits than a private carrier

Subsidize the cost of insurance, either directly or indirectly.

- Would provide immediate relief to Housing Providers to a much greater extent than other solutions
- Would not address the underlying issues that caused insurance costs to rise so rapidly

Combine elements of the above to provide immediate relief while addressing the underlying problems over the long-term. Examples include:

- Partially or fully subsidizing the cost of mitigation measures
- Establishing a publicly capitalized (re)insurer that offers premium credits to Housing Providers that make investments to mitigate risk

Policy Options Summary

LEGEND:

- ✓ Expected Benefit
- ✓ Possible Benefit

#	Policy Options	Reduce TCOR	Increase Availability	Subsid-ize
1	Create **Public Reinsurer** to reinsure private insurers		✓	✓
2	Create a **Public Insurer** to insure the first layer of insurance policies for Housing Providers		✓	✓
3	Establish a **Deductible Reimbursement Fund** to pay for costs in Housing Providers' deductible layer			✓
4	Encourage **physical risk mitigation** by subsidizing the cost of to install water and fire mitigation	✓		✓
5	**Mitigate behavioral risk** by changing state law to provide Housing Providers with more control over which tenants they house, while protecting PSH residents who require inpatient treatments	✓		
6	Create a new **Public Renters' Insurer** to provide renters' insurance for individuals placed into Affordable Housing units		✓	✓
7	**Increase building inspections'** frequency and scope to identify risks such as electrical fire and roof leaks that increase risk	✓		
8	**Enhance building codes** for Housing Providers to mitigate property damage and personal injuries and provide public funding to assist Housing Providers to become compliant	✓		✓
9	Increase state **funding for social programs** that can be administered by or in partnership with Housing Providers	✓		
10	**Subsidize the cost** of insurance for Housing Providers			✓
11	Enact **negligence standard legislation** so that certified Housing Providers can only be held liable for actions of their residents or guests if they display gross negligence or bad faith	✓	✓	
12	**Combine options** such as (i) Establish a Public Insurer that accepts the first layer of insurance coverage for Housing Providers; (ii) offer premium rate credits for approved risk mitigation initiatives implemented by the insured Housing Providers	✓	✓	✓

Potential Funding Options

- **Existing premium taxes** could be earmarked to fund some portion of these solutions. The small size of this market means that a relatively small percentage of allocated premium taxes could potentially fund a substantial portion of these solutions.

- Money could be collected via special **insurance policy surcharges** or fees. Generally, insurers can pass such surcharges or fees to policyholders via offsetting increases in premium rates.

- The current PSH OMS and O&M Housing Trust Funds derive much of their funds from a **document recording fee** which is currently $183. This recording fee could be increased, or additional fees levied, if the Legislature deems this appropriate.

- Funding could be **diverted from general funds** or could be raised from **other taxes or fees** (perhaps in a manner related to this issue, e.g., an additional property tax on commercial residential property).

Quick Break for…

NOW: A few questions and answers

NEXT: Discussion of Policy Options

Policy Options

Policy Option 1 - Public Reinsurer

Description: Create a new Public Reinsurer **to reinsure commercial insurers' risk** from Housing Providers above a selected threshold. The Public Reinsurer could subsidize the cost if it charges less than actuarially sound premiums, can operate more efficiently, or can charge a lower profit load than a private reinsurer.

Rationale: Reduce reinsurance costs and increase market attractiveness for insurers.

Risks .... and Potential Mitigants:

Risks	Potential Mitigants
▪ Private insurers may not participate	Offer attractive reinsurance rates and mandate that a portion of the reinsurance savings be passed on to the policyholders
▪ Public reinsurer may mismanage claims	Recruit experienced claim managers or outsource to a TPA
▪ Public reinsurer may have high claims	Implement policy options designed to reduce insured losses

Dependencies:

- Initial capitalization from the state
- Ongoing funding from the state if the premium rates are lower than actuarially sound rates

Policy Option 2 – Public Insurer

Description: Create a new Public Insurer **to insure the first layer of claims** from Housing Providers up to a selected threshold. The Public Insurer could subsidize the cost if it charges less than actuarially sound premiums, can operate more efficiently, or can charge a lower profit load than a private insurer.

Rationale: Reduce Housing Providers' cost of claims below their deductible and improve attractiveness of the market to commercial insurers by eliminating their liability for high-frequency claims.

Risks .... and Potential Mitigants:

Risks	Potential Mitigants
▪ Private insurers may not want to insure higher layers due to uncertainty about Public Insurer's claims handling	▪ Offer attractive reinsurance rates and mandate that a portion of the reinsurance savings be passed on to the policyholders
▪ Public insurer may have high claims	▪ Implement policy options designed to reduce insured losses

Dependencies:

- Initial capitalization from the state
- Ongoing funding from the state if the premium rates are lower than actuarially sound rates

Policy Option 3 – Deductible Reimbursement Fund

Description: Establish a fund to reimburse Housing Providers for expenses in their insured deductible layer.

Rationale: Many Housing Providers have increased their deductibles as a method of mitigating large premium increases. Choosing a higher policy deductible temporarily assists Housing Providers in meeting their budgets, but ultimately can result in even greater financial pressures as they are forced to absorb significant losses in the deductible layer. A deductible reimbursement fund would assist Housing Providers in meeting their budgets.

Risks .... and Potential Mitigants:

Risks	Potential Mitigants
▪ Total Cost of Risk is not reduced, and Housing Providers may have less incentive to try to prevent small claims.	Participation in the program could be dependent on the Housing Provider's implementation of certain risk mitigation actions.
▪ Housing Providers may overuse this fund.	Put caps on the amount that Housing Providers can collect per claim, and in the aggregate, in a given time period.
▪ Funds may be exhausted, leaving Housing Providers with too-large policy deductibles and no way to fund them.	This fund could provide temporary relief to Housing Providers while longer term solutions (such as risk mitigation actions) are put into place.

Dependencies: A specific study, with a larger experience base, should likely be engaged to determine initial funding based on specific caps, as well as subsequent funding that may be necessary

Precedent: Oregon implemented a plan similar to this to address some insurance and claims cost for PSH housing

Policy Option 4 – Physical Risk Mitigation

Description: Encourage physical risk mitigation by subsidizing the cost to install water leak and fire detection and suppression systems to reduce the total cost of risk

Rationale: Water and fire damage are the two largest causes of loss. Effective mitigation devices are available, but many Housing Providers lack sufficient financial flexibility to pay for their installation. Subsidizing the cost would enable their installation, thereby reducing the risk of sizeable claims

Cost Range: Certain fire suppression devices can cost as little as $40 per apartment unit, while sprinkler system installation in a multi-unit apartment building could cost many thousands of dollars

Potential Impact:

- Material reduction in property damage and personal injuries (i.e., the total cost of risk) and resulting claims filed
- Potential premium discounts from leading carriers. One mitigation device manufacturer indicates on its website that admitted insurers offer discounts ranging from 5% to 7% of the total premium after installation of a device that costs approximately $40 to $80 per apartment, which means the units would pay for themselves in the first year

Limitation: It is not clear how much premium credit insurers will give for these measures as most of the insurance companies in this market do not file rates in Washington

Policy Option 5 - Behavioral Risk Mitigation

Description: Implement changes to state law to provide Housing Providers with more control over which tenants they house, while adding protections for PSH residents in need of inpatient medical or mental health treatment. Changes:

1. Empowering Housing Providers to screen applicants and deny entry to any that pose a greater risk to the property or to other residents in the property, or to residents that they believe they are currently not equipped to best service
2. Implementing a streamlined, accelerated process by which Housing Providers can relocate residents who may be decompensating, in critical need of inpatient treatment, or pose a serious risk to the property or other residents through a state-run program
3. Holding a PSH resident's unit for them temporarily if they are transferred to an inpatient medical or mental health facility for treatment

Rationale:

1. Behavior of a small percentage of residents poses serious risk to property or other residents and may create significant losses for the Housing Provider or their insurer.
2. The current process to relocate a resident may take many months – during which the resident's behavior may lead to sizeable insurance claims
3. PSH residents can lose their unit automatically if they are transferred to an inpatient treatment facility, creating a disincentive for a PSH resident to seek or accept treatment when in crisis

Challenges and Limitations

- There may be resistance to legislation that gives Housing Providers more control over which residents they house or that results in PSH housing units being unoccupied
- The definition of PSH is that entry must be "low barrier" so any changes to entry rules would need to be carefully considered
- Grants and trust funds frequently require Housing Providers to demonstrate that their units are occupied

Policy Option 6 – Public Renters' Insurer

Description:

Create a new Public Insurer to provide renters' insurance for individuals placed into Affordable Housing units

Rationale:

Based on the analysis of the small available dataset, approximately 30% of Housing Providers' insured losses are driven by tenant behaviors, but their lack of renters' insurance means that the Housing Providers' insurers cannot recoup their losses

Challenges and Limitations:

- This solution transfers a portion of the risk to the Public Insurer.
- If the premium charged by the Public Insurer is actuarially sufficient, then tenants and housing providers may not be able to afford it
- If the premium is less than actuarially sufficient, then the Public Insurer will require ongoing funding from the state to remain viable

Policy Option 7 – Building Inspections

Description: Increase the frequency and scope of building inspections and/or appraisals to identify risks and identify risk mitigation measures that have the potential to reduce insurance costs

Rationale: Insurers require up to date information to properly underwrite and price risks. In the absence of recent inspection reports and/or appraisals, insurers may make overly conservative assumptions about the condition of the properties that results in higher premium costs

Limitation: Building inspections are conducted by local municipalities rather than by the state. Municipalities may not be willing or able to invest the necessary resources to increase the frequency and scope of property inspections

Estimated Cost: $120 - $230 or more for inspections, and potentially much more for appraisals depending on the property size, type, location, and the scope of the appraisal

Policy Option 8 – Enhance Building Codes

Description: Enhance building codes for affordable housing properties to require certain minimum standards designed to mitigate property damage and personal injuries, coupled with public funding to assist Housing Providers to become compliant

Rationale: Enhanced credibility in the underwriting process, reduce insured losses over time, and have the potential to reduce insurance costs for properties that are compliant with the new code

Impact:

- For **new properties** being built, this solution will increase construction costs but may reduce future insurance costs
- For **existing properties**, insurance costs may increase in the near term but should decline over time after implementation of the new mitigation measures

Challenges: Existing properties are typically "grandfathered" when new building codes are introduced, so it will take many years to have a material impact on total cost of risk

Policy Option 9 – Increase Funding for Social Programs

Description: Increase state funding for social programs administered by or in partnership with Housing Providers

Rationale: Residents who suffer from mental health or substance abuse challenges may need ongoing counseling and medical support. If that support is unavailable, they pose a higher risk of damaging property or injuring other residents.

Cost: If the Legislature chooses to pursue implementation of a policy option similar to this, it will need to work with Housing Providers to determine the appropriate services and their relevant costs

Limitations: It is difficult to tie these benefits directly back to insurance costs. However, over the long term, insurers may offer premium discounts if claim costs decline

Policy Option 10 - Directly Subsidize the Cost of Insurance

Description: Directly subsidize the cost of insurance for Housing Providers. This could take several forms:

- Increase the amount of funds that the Commerce Department provides to Housing Providers, to at least partially offset their increased cost of insurance. Increasing this funding is the fastest way to offset the rising cost of insurance so that Housing Providers can continue to execute on their core mission.
- Subsidize the cost of implementing mitigation measures that reduce the total cost of risk.

Rationale: Insurance costs for extremely low-income housing have risen very rapidly over the past few years. An immediate increase in funding provided to Housing Providers would more realistically capture current insurance costs.

Cost: The cost of this proposal would depend on the amount of subsidy that the state wishes to provide. If the state wishes to subsidize 25% of the total cost of risk, this would require estimated additional funding of between $2.7 million to $3.5 million per year.

Limitations: Such a proposal would do nothing to resolve the issues that led to these rate increases in the first place. If funding is immediately increased without any other action, it is likely that a similar crisis will emerge in the future.

Policy Option 11 – Create Negligence Standard

Description: Enact legislation to create a negligence standard for certified Housing Providers so that they can only be held liable for actions of their residents or guests if they display gross negligence or bad faith.

Rationale: Insurance professionals told us that liability claims are a growing source of losses for Housing Providers. When a resident behaves illegally or causes danger to others, the Housing Provider and its insurer may be sued for the behavior.

Impact: Certain qualified Housing Providers could only be sued for negligence in the event of gross negligence or bad faith – if they became certified in resident safety by taking certain state-determined courses and by demonstrating compliance with state-determined resident safety standards.

Risk: As PSH Housing Providers are required to maintain low barriers to entry, including consideration of criminal history, Washington State may wish to lessen their liability in the event of resident or guest behavior, provided that the Housing Provider could demonstrate that they had been compliant with standards.

Over time, this should reduce liability claims and expected losses that insurers must reflect in their pricing.

Policy Option 12 - Combinations

Many of the policy options previously identified can be combined synergistically to provide more benefits than would be the case if implemented individually.

For example, if a public insurer is established, the Legislature could mandate rate credits for certain risk mitigation measures. The Legislature should carefully consider whether combinations of these policy options can be combined synergistically to optimize both short-term and long-term benefits.

Q&A