NATIONAL FLOOD INSURANCE PROGRAM

# FLOOD INSURANCE MEETING

Scottsdale, Arizona
January 17, 2001
8:40 o'clock a.m.
Day 2 of 3

Prepared for:
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P R O C E E D I N G

commenced at 8:40 o'clock a.m. on January 17, 2001, at the La Posada Resort, 4949 East Lincoln Drive, Scottsdale, Arizona, before MICHAELA HERMAN DAVIS, a Certified Court Reporter, in and for the County of Maricopa, State of Arizona.

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A P P E A R A N C E S

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MR. EDWARD PASTERICK

MR. EDWARD L. CONNOR
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R E C E S S E S T A K E N

(None.)

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MR. LEIKIN: First of all, good morning.

I wanted to make one announcement this morning so that you know what's happening with our various casts of characters in the FIA and other places.

Of course, you know we're likely to have a few changes, of course, with the transition, but within FIA, we have a couple of changes that we made.

Most of you probably know Roland Holland who has been the division director for operations. Roland is still with the FIA, but he is off on a one-year sabbatical-type activity with the Brookings Institution. It's a program where he will be working on the Hill at some point very soon. They will be identifying a particular office, either committee or member, who he'll be working with. And it's also a training opportunity.

And so with his leaving a vacancy for the year, we've shifted some folks around. Ed Pasterick has graciously agreed, without kicking and screaming, to be the acting division director for the operations division in FIA.

And then for the finance and administration division, Ed Connor is going to be the acting division director. Doesn't mean Ed is giving up his liaison role with the committees and such, but we've just added to his burden. That's the way we do things. We just -- no one gets rid of any responsibility.

One of the things we thought we'd do this morning, just to be sure that everyone knows everyone, is to have people stand up and tell us who you are and who you're with and maybe what committees you're on.

(Audience member introductions.)

MR. PASTERICK: I guess my job today is to guide us through some discussion of how we're going to compensate, how the program is going to compensate the companies and what may be the best formula of compensation.

And may I, just to give a little bit of background, there has been some turbulence surrounding the compensation formula, and I think it's probably brought us -- just along with the fact that we've been around for 17 years, and maybe it's time to look at our compensation formula and to weigh some possible alternatives based on all comments that we've had.

Discussion, complaints, whatever you want to call it.

Just as a -- the compensation formula, the expense allowance, I guess we'll -- the Write Your Own expense allowance has been basically the same. At least, it's the same concept for the 17, 18 years of the program with some either minor fiddling, or major fiddling, depending on where you sit, in terms of the exact percentage. Depending on who you're talking to, the companies are either getting rich or getting poor. But the formula has served us -- I think the formula has served us well.

The most important aspect, I've always felt, about the Write Your Own expense allowance is that it's based on objective data. Now, whether that data accurately reflects true costs or not -- and Lynn and I were talking before the meeting as to how reliable those numbers are. They are the best numbers, at least the best numbers available, and they have allowed us -- they have been very defensible numbers over the years.

And while you have to report up within your companies on costs, we have to report up to a number of different players on expenses. And to be able to base our compensation to the companies on the Best data has served us very well in this program.

And I have to say, that, as Frank was saying yesterday, we have had very rare occasions when we've really been challenged on those numbers. And when we have been, there hasn't been any -- once we've explained what the basis is for our compensation, I think we've been able to defend them very well.

The last eight or nine years, just to trace a little bit of history, we used the Best net number, which includes the cost of reinsurance, up until, well, the last two years. I'll get into that issue in just a minute because I know that's a sore point with some folks. When -- and that number varied from year to year depending on what the Best number was.

When Elaine McReynolds became administrator, the Best number was 32.6 percent. With that coincided a great deal of concern about whether the program was sufficiently marketing itself.

In the aftermath, particularly of the 1993 Midwest floods where we had very, very poor penetration, for various reasons, some understandable. In many cases people didn't have mortgages. It's beside the point as to why. But it became a very -- it became a point of some concern that not enough people had flood insurance, and despite the fact that they were in flood-prone areas, we're still having to turn to disaster assistance for relief.

Elaine came in with a real concern about marketing, and we developed a concept of tying a portion of the expense allowance to some -- to the achievement of some marketing notes. We went about that in a way that the companies, understandably, were not very happy about because we took 32.6, and we just removed 2 percent, dropped it to 30.6. And the companies had to earn back, in effect, the 2 percent by achieving certain marketing goals.

That -- again, we never -- we didn't change the 32.6 from year to year because, as I said, Elaine was just -- just didn't believe they were particularly accurate numbers. At the same time, she didn't have better numbers, so we just stayed with the 32.6.

After a few years and the companies raising their real concern because we called it an incentive, and, of course, from the companies' standpoint, it was a penalty; that by removing 2 percent, all we were really doing was penalizing the companies for not achieving certain marketing goals as opposed to incentivizing it.

So gradually -- and I won't go into all

the various permutations. What we tried to do was to build a true incentive into the program, and that is, to start with the Best numbers as the baseline for the program. And then we are currently at a -- we are currently at 2 percent above that that the companies can earn by, again, accomplishing certain marketing goals.

The other, of course, change, that occurred over the last couple of years has been because the Best is now publishing or has been publishing both the net expense number as well as the direct. And our program doesn't require purchase of reinsurance. It became difficult for us.

And I guess I'll have to put it this way. Once those numbers get out there, it becomes a little difficult for us not to give some -- if we're going to defend the validity of the Best numbers, then it seems as though we had to recognize the fact that the Best direct may well reflect more accurately the expense ratios or the expense allowance and the expenses of the program.

And so we went to the direct number, which varies from the net number from year to year. But we've now also gone back to adjusting the allowance based on the change in Best numbers over the years.

So that's where we are. And at the moment, our primary negotiation is really what to incentivize for the 2 percent above the base. Do we incentivize growth or retention? And I think we'll need some input, and we'll have discussions as to what we believe as a program we should incentivize.

Just as an example, one of our concerns is the whole area of geographic distribution of our policy base. Our policy base is very much concentrated in a number of large states. And one of the vulnerabilities of the program -- you know, this is really us in Washington who have to answer the questions from the Hill and every place else when we have a flood and how come people don't have enough insurance.

Because if tomorrow a flood hits Toledo, Ohio, I will guarantee you that a lot of people are not going to have flood insurance in Toledo, Ohio because it hasn't flooded in Toledo, Ohio. If a flood hits Tampa, we're not going to have a problem.

But it seems as though every year or two we get a major flooding event, and we can cite them over the '90s. The Midwest, of course, was the site of the two biggest ones. Fargo, North Dakota was very much underinsured in terms of flood insurance when that flood hit up there. And it's not as though Fargo has not been aware of it. And it's not as though it's the first time. Or Grand Forks. It's not as though it's the first time they have ever been flooded. But in many cases, I guess, they thought they have had their flood for the last 400 years, and so they are okay now.

But in any case, I think the idea of possibly incentivizing things like geographical distribution may be something we want to put on the table. But that's not the point of our exercise today.

We've come to a point where I think that maybe I can say you've gotten through to us a little bit. That maybe the Best numbers aren't accurately reflecting what the true costs of the program are.

On the other hand, just to defend ourselves, we've kind of resisted making any changes in that because we haven't had a basis for it.

And as I said, we're well served by being able to base our numbers on some objective data, but I think maybe what we need to do from here is to start to identify some alternative ways that can be based on legitimate data to explore some alternative formulas of compensation.

Or, at the outside, as Frank said to me yesterday, you ought to get out of the expense business. And, of course, that's always a consideration, is to separate the whole expense portion of the program and the pure premium portion of the program and just give us the premium and the companies compete. And by the way, I think that's -- that may be one of the alternatives we should at least give some discussion to today.

We've got -- we've put together a few possible models that we'd like to break up into some working groups today. To -- these aren't necessarily the only ones, and we may not even decide to discuss some of these, but what we thought we would do is to lay out three or four or five possible alternative models to where we are now. Actually, I suppose, where we are now being one of the models for compensation. And just to break out in groups and talk about the pros and cons of each of them. And come back later today and then tomorrow morning and maybe talk about where we proceed.

In terms of time frames, any adjustment of the expense allowance is -- at this point is impossible to effect until the arrangement year that begins in 2002, October 2002, because we have to go through the proposed rule process. And it's basically the government bureaucracy.

So what we're talking about here is if we come up with some adjustments, it will happen next October. For this year, we're -- we will -- I think we haven't published a proposed rule, but we will be discussing possibility in adjusting the incentive portion of the program. We still have time to do that, and I think it's something worthwhile pursuing.

Let me just walk through the models that we laid out. And by the way, if any of you spent some time last night and were bored and decided to come up with some other alternatives, we're open to those today too. So I'm going to open the floor to any other suggestions apart from the five that we have here, actually six that I've listed on mine, that you may have that you may want to have us consider over the next day and a half or next day.

The first, of course, is essentially really proposals to -- probably we should talk about number two first, because number 2 is really our current formula. And that is, to use the Best direct numbers and then fiddle with the incentives.

Now, when I say "fiddle with the

incentives," I don't mean the actual numbers. I suspect a 2-percent incentive is probably a legitimate enough incentive. I think it does provide some additional compensation that I think is valuable to the companies, but what we attach that to is something that I think maybe we need to discuss.

And I think from here, I know Ed put together a small working group -- what was it, last year or the year before? -- and talked about how we may structure that. And I think that's something we might want to do again.

Yes, Rhonda.

AUDIENCE MEMBER: Will you be able to provide us with data as to how the incentive piece was broken up by company? And I guess what I'm saying is, how successful it was within the companies. Because I think that would be helpful in us understanding what direction you're going. Are you going in a direction because very few accomplished it? Or you're going in a direction because lots accomplished it?

MR. PASTERICK: We're not particularly concerned about who accomplished it or didn't accomplish it. You know, our growth has not been great over the last couple of years, and that's a factor of weather. It's -- we understand that there's only so much sometimes that can be done to just get people to buy flood insurance, and so many other factors feed into it.

We haven't been as much concerned about whether companies have achieved it or how many have or haven't, as much as the fact that we're not at all sure from our standpoint that just pure growth, no matter where it is or of what nature it is, is the ideal goal for the program. But we could provide those numbers.

I'm not talking that part, but what I'm saying is our concern has not been based on how much company -- how many companies have been meeting goals. Actually, across the board, I think they have done fairly well. And, I think, in general, you know, for the purpose that we assign to it, it's worked. I think it's worked fairly well. So we're not really questioning the incentive concept as much as we're questioning should we be trying to accomplish different kinds of goals through those incentives in terms of marketing.

And I have to say that I keep coming back to the same thing because I just think that the area that we're most concerned about has to do with geographical distribution. Areas like the Midwest, areas like the Southwest, excluding Texas. I just think we don't have very good penetration in those areas. And I have to say that it's difficult for us to know what's the best way of making that happen. But maybe if we attach some incentive dollars to that, we can get some focus on that from the companies.

So again, it's not really any unhappiness with the incentive concept as much as it is what are we trying -- of course, Howard, every time we talk about growth, Howard from his actuarial seat, we're concerned about whether we're getting, you know, do we get all -- a policy is not necessarily a policy in this program, you know, depending on the nature of the business you bring in.

Now, I don't think we're in a position where we're going to start to attach any particular -- but I don't know this -- but, you know, whether we'll distinguish prefirm versus postfirm. But a prefirm policy that we're already subsidizing is new business, but it's not necessarily good business. At the same time, we can't turn it away. And to an extent, we pay -- we benefit from that politically.

I think we need to keep understanding that even if we're losing money by paying claims on properties that are poorly constructed or old or whatever, we derive some benefit politically from the fact that they are coming to us for compensation and not going to federal disaster assistance. So, you know, we can't ignore that kind of public policy objective of the program. At the same time, maybe we need to break down the nature of the business.

Another area is commercial. You know, so much of our business is residential, single-family residential for that matter, but condos, of course, are a big part too. But, you know, commercial, small business, you know, things like that.

Anyway, that would kind of be the components of number 2 where, again, we wouldn't -- we would not change the base allowance. We would just keep writing with the Best direct number.

Number one would be actually, in effect, probably going back to the Best net number. And again, leaving the incentives pretty much the way they are now.

Now, we may, as we discuss these, combine some of these maybe in our discussion groups because some of these are kind of different variations of the same concept. And maybe it's not worth breaking out in separate groups to discuss them.

But there -- it's really probably a

question of without having necessarily better data, acknowledging, because of some discussions we've had, that the costs to the companies of the program is not accurately reflected in the expense allowance. And to maybe add -- when we put on here an additional amount, a point or two, I'm not sure we would pick an arbitrary number, but maybe just go back to the Best net number rather than a direct number. Which generally, I think, has worked out to be about a point, between a point or two difference the last couple of years.

And again, that doesn't really require any more discussion. Again, what that would do is kind of accept the companies' experience and comments and concern and basically say, We believe you. Not that -- again, this is not a question of not believing the companies. It's a question of hanging our hat on something that we can go to somebody else with.

When we have our discussions here, I don't want to say it doesn't matter what we conclude, but we have to also be able to defend that outside of this room.

AUDIENCE MEMBER: Ed, excuse me. Who do you defend this to? What committees of Congress?

MR. PASTERICK: The banking committee is

the authorizing committee. And, of course, we have to go in front of appropriations, and then if GOA decides they want to look at a program.

From a positive standpoint, we've been notified by the Congressional Research Service that the National Flood Insurance Program is going to be one of the -- I forget the term they use, the feature program or -- what's the term that they used?

MR. LEIKIN: They indicated their intention to raise it as a major issue for the next House on a series of issue papers. We haven't heard again from them, but I don't know if it got dropped.

MR. PASTERICK: And they told us that and we have interpreted that as basically a positive thing because there are some issues that we're dealing with that, you know, hit the radar screen over the last couple of years, primarily repetitive loss and the inordinate cost of a small number of properties, of how we're going to deal with that. That's going to be one issue. I suspect things like the borrowing authority and exposure.

You know, we had a meeting with OMB and told them what our exposure was of, what, 480 billion dollars and -- I'm not sure about the 480, but the billion is right. And it takes them by surprise. I mean, it's like this quiet small program with this huge exposure out there. And so, you know, I think they just want to make sure. They take a look at it, and any time you look at it like that, any number of issues are apt to come up.

And so somewhere along the line, we'll explain to them how we distribute this product, and we'll tell them that we have this arrangement with approximately 90-some insurance companies and the companies retain 30-some percent of the premium for that -- for their services. And they will say, Where did that number come from? Isn't that a lot of money? Because, you know, none of this is ever put in any kind of context. They are all absolute numbers. They don't put it in a context of some larger perspective.

So I'm not suggesting -- and by the way, one of the policies, so to speak, that we have always benefited from is that we have tried to anticipate very much the kinds of things that this program is subject to in terms of questioning, and so we've brought down our own scrutiny on ourselves. We want to be sure that we can answer the questions to ourselves because then when somebody else asks, we're not scurrying around trying to come up with defensible positions.

So, those are just a couple of the kind of -- and we have our own IG. It's an inspector general. Again, it's not so much always grounded in any concern, but when the inspector general comes out with their work plan every year and they look through the agency and they say, What can we look at every year? You know, which particular area they feel they should take a look at and see if it's working properly.

And again, appropriations. Every year when we go up for appropriations, you never know which member of the appropriations staff, for example, had some constituent in the last month or so that felt they got robbed on a claim, complained to that particular member. And so that hearing becomes the opportunity to ask, What the hell are you people doing down there? You know, that kind of thing.

AUDIENCE MEMBER: As of October 31st, it was 551 billion.

MR. PASTERICK: Okay. It's the second biggest to Social Security.

AUDIENCE MEMBER: Is that the P&L or aggregate exposure?

MR. LEIKIN: Aggregate exposure.

AUDIENCE MEMBER: So it really isn't

that exposure.

MR. LEIKIN: The P&L.

AUDIENCE MEMBER: And that's against 1.5 in premium a year.

MR. PASTERICK: And the third model that we've laid out here is the possibility of maybe having the companies develop a three- to five-year plan, business plan, that would calculate what their expenses would be and, in effect, get into negotiation with us as to what their expenses might be. It would be certainly of much more burden because we'd be negotiating company by company, in effect. But, I think it's something that maybe we could spend some time wondering if it could work.

What that would do, of course, is to take into account the different factors that affect the various size operations, various -- the generic differences, so to speak, between different operations. I think it could well be a more accurate reflection of the true cost of the program.

I'm not going to get -- I think on all of these, I don't want -- I guess I have to be careful. I don't want to get into the pros and cons of either of these. I think it's something for the group here to talk through when we break out into the break-out sessions. But, you know, I think it's something maybe to throw on the table. If for no other reason than to say we considered it, and for a variety of reasons, we're not sure it's workable, or we think maybe this is the way to go. But I think it's worth at least throwing out there and having us discuss it and asking ourselves whether it could work, and if not, why not. And if so, why it can.

And the fourth is really more a matter of trying to address -- when we talk about the adequacy of the expense allowance for the companies, the factors that often -- actually that pretty consistently come up as the reason why it's not adequate has to do with some of the activities that we asked the companies to undertake over and above the day-to-day selling and servicing of insurance policies.

And we mentioned things like the PRPs, the various kinds of activities that are costly. And your contention is that, you know, the expense allowance is fine for a certain, you know, for the day-to-day kind of business. But when you ask us to do this and then you ask us to do that, that gets to be expensive. And that's not really reflected in there.

And really, 4 and 5 are kind of related in that sense. And in the one case, it would be a matter of leaving the expense allowance right where it is, but then when we come up to certain activities that we are asking the companies to accomplish, that maybe we can have many of those done through bureaus, through bureau service. Either our bureau, or we can contract it out to ISO or -- I'm not -- I won't get into how we might make that happen.

But, you know, the bureau, of course, already provides a number of services that the companies benefit from. Maybe we could take a harder look at some way of relieving the companies of having to accomplish those activities on their own, and we could do it through the bureau. So, in effect, we would be providing some bureau services at no cost to the companies. So anyway, that -- that would be one way of handling it.

The other way, of course, would be to establish some kind of a baseline for normal day-to-day operations and then be able to attach a certain compensation to some special activities that need to be done for the benefit of the program for either underwriting accuracy or for some other mitigation.

And you know, of course, as Howard was saying yesterday, we've got an important mitigation responsibility in this program that we can't ignore, and sometimes the only way to make that happen is through the insurance program.

Now, believe me, we resisted, we fought the Monroe County thing. It's not something we kind of stepped forward and, you know what, we can really help you out here. We fought that tooth and nail, but when you get into that political climate of, boy, all of the noncompliant properties down in Monroe County and, you know, you're insuring them and they can't get into the property and the only way we are going to be able to do it is don't renew them.

Theoretically, it sounds like a neat idea to get something accomplished, but the people that think it sounds like a neat idea don't realize the ramifications and the implications that has for the companies. So we're -- we are, in fact, your friend in court on those issues, but sometimes we don't always win those battles.

So in any case, what model number 5 would do is maybe to develop some kind of compensation fee or compensation package or some way of attaching a degree of compensation for a -- certain levels of activities that may go above the baseline. And I do think that's worth -- we would have to identify what those activities are. We'd have to figure out how we would compensate them, whether it be through some percentage or whether it be through some pure dollar per policy kind of number. I'm not -- that's for the group to talk about.

The last alternative that I marked down did have to do with this notion of -- let me just step back. One of the things that's been important to us, as Frank was saying, as long as it was always identified as the federal program, that there be viewed to be a certain equity, equitable treatment of policyholders so that everybody is, in effect, paying the same premium for the same coverage, no matter who they go to and who they get their flood insurance from.

Maybe we have come to a point where that -- where we are -- the program is sufficiently institutionalized, sufficiently out there among the public, and it will allow for the kind of variations in premium that will reflect different expense ratios and the like from company to company.

I don't know -- I have to say that I'm not sure how much, and maybe I'm not necessarily in the office to hear the complaints, but I'm not sure how much we still hear about the fact that so-and-so is paying less for flood insurance than I am or things like that. I'm not sure if that's a -- if that's still as prevalent a complaint as it once was.

And so maybe it is time to just talk about some -- and this is where, of course, I am the big picture person. When we get down into the numbers, I don't know how it would work, but the idea, of course, would be that we wouldn't have to worry about the expenses. You would worry about the expenses. You collect the premium. You give us the pure premium that we need to pay losses from. And whatever the expense component is would be up to you to determine and to compete in the same way that you do with other lines.

I think it's worth talking about to see if it can apply to this program.

AUDIENCE MEMBER: I know that this was brought up in, I think, the meeting in Chicago that we were all at, but have you all looked into the way that the reimbursement is performed on the Medicare products? You know, I'm not familiar with it, but I know that it's based on some expense and overhead costs. And then there's, I think, some kind of profit margin built in. I don't understand it, but I know that our company does participate.

MR. PASTERICK: Anybody else here familiar with the Medicare concept?

Because that's one -- that's a possible thing to look at. Maybe it is a possible model for us. But I have to say that we have -- no, we haven't done that.

AUDIENCE MEMBER: Ed, I think the companies may have been under the impression that today's meeting would impact the expense allowance in October of this year. Now, are you saying that it is not, the discussions today?

MR. PASTERICK: To the extent that we can talk about the incentive portion, we hadn't intended to spend much time on that. We may -- we may -- we still have time this year to consider some adjustment for this October. I will say that.

For example, there may be time, but I'm not sure, if we come -- if we come to adjust the net versus direct. But I think we need to talk about what would be the basis for that, because the rule hasn't yet gone to proposed rule, and we might be -- depending on how much of an adjustment. I guess I'm just trying to deal in realistic time frames.

Depending on -- for example, if we took one of the more radical kinds of steps, like just allowing the companies to compete on expenses, there is simply not a way that we can make that happen by October.

However, if we believe that there are some adjustments that can be made within some realistic parameters that don't require a great deal of discussion, great deal of analysis and the like, we probably still have time to make that happen by October.

I think it's -- it depends on what this group comes out with as maybe the most feasible way of dealing with the expense allowance. A radical departure is just inevitably going to take more time. An adjustment of, let's say, relatively minor proportions -- and maybe that's where we are. Maybe we are strictly at a point where we don't need radical adjustment to the expense allowance but just need to make some minor adjustments to it that would be sufficiently significant to the companies. We might be able to make that happen by October.

Howard, do you have any thoughts on that?

MR. LEIKIN: I guess I would not like to

see the opportunity we have here today and tomorrow morning to limit ourselves to some quick fix as opposed to really taking a look at what an appropriate model for compensation should be.

We have a couple of, I guess, short and longer-term concerns, but we should use this opportunity to take a look at that longer term.

MR. PASTERICK: And maybe we can consider some minor quick fix in October with the anticipation that maybe we need a better fix over the long term.

MR. LEIKIN: Without getting into that longer term, it's still a vulnerable figure for anyone coming in, any new administration coming in and asking questions and having to answer other questions from various congressional committees and such. And others.

AUDIENCE MEMBER: Well, I understand that we need to look long term in anything that we talk about, but I think there's a problem that needs fixing; that our company's position is that we're here to do what makes sense. Everybody wants the same thing.

And I'm just maybe a little confused as to the intent of this meeting because when we talked about meetings as quickly as possible, the idea was to get the expense allowance in line with what companies' expenses are today, as they have increased significantly for a lot of reasons as the years have gone by. And whether we talk about marketing incentives or whatever, a company needs to meet their expenses, and then worry about incentives and everything else after that. If they are to -- I don't want to say continue, that's an individual decision.

We need to be accountable to our senior management for the bottom line. And many of us have been asked to do that. And, I guess, I thought maybe we were here to look at, even on the short term, some things that we could do to get the expenses in line with what true expenses are.

MR. PASTERICK: And maybe we can do that.

You have to understand that when we first -- when this -- I think we probably had gotten into a pattern of maybe having a meeting every year about this time, primarily to talk about the incentive portion of the program. The original intent of this meeting was not to be this size group or this number of days, but just to get a small group together to talk about the incentive portion of the program.

In the meantime, the adequacy of the expense allowance has come up for major comment from the companies, and I think we've become -- we became concerned that maybe we do need to take a harder look at it.

Now, we're not coming in with any preconceived notion as to what the fix to that is, but we felt that maybe it's sufficient, it's of sufficient concern that maybe we need to entertain a whole number of alternatives that aren't necessarily, as we say, quick fixes but will serve the program.

Again, we have a formula now that has served the program for 17 or 18 years, for better or for worse. At some point maybe we need to step back and say, What kind of a formula is going to serve us for the next 17, 18 years?

Now, there may be some adjustments that we can make to kind of buy us time until we identify a longer-term thing, and hopefully that is something that can come out of this group. But because of the regulatory process, when you make major shifts in the program, it just takes that much longer.

Now, all of that said, as I say, without coming into this meeting with any preconceived notions as to what is the best formula, maybe this group will decide that the best formula is the formula we have now with a little tinkering here and a little adjustment there. Lynn Barr thinks that's the case. She says, Let's keep it simple. And so we may be, in fact, doing exactly what you want to see come out of it.

What we didn't, however, want to do is to close off the possibility that maybe we've reached another time; that maybe we've come to a point in the program where we need to relook at how we're compensating and on what basis we're compensating. And so it was not a question of saying this is what we have to do, but we certainly didn't want to close that off.

Because I think we are at -- I don't want to use dramatic terms like "watershed." We are not at a watershed. And let me also tell you that one of the reasons we wanted to do this in January is we have an administrator who is very receptive to this. And I'll just tell you flat out. If Elaine McReynolds -- and this is not to criticize Elaine or compliment her. That's just where she was. If Elaine McReynolds were our administrator, we wouldn't be having this meeting. Or if we would be having this meeting, it would be much more contentious, and the potential might well be a lot more unsettling.

So I think the other -- Jo Ann has been concerned about this, and I think she's been open to revisiting this in a way maybe that we haven't done before. So part of it is that. That's probably -- that's probably maybe an ambivalent answer. I'm not saying we're not going to come up with the best fix possible, it's going to be a quick fix. I don't want to go into this saying that because it's quick, it's best.

AUDIENCE MEMBER: I think we do need to use this time in our groups to sit down and think outside the box. There's no bad idea. Everybody come up with a good idea and come back and let's see what we end up with. And it may be that, yes, it is a long-term solution, and it's not going to be done immediately. But I'm with Jack as well. If it looks like it can be done and we do have some time until April and it can get in there, I think you'll get 100-percent agreement to get that in.

MR. PASTERICK: And we're open to that. We're not closing that off as a possibility at all.

AUDIENCE MEMBER: And if it's not, and the long-term solution is where we're going to go, I won't call it a quick fix, but adjustments, for example. The retention is 90 percent base, yet we're showing the average company is 84 with a 3-percent rollover. So we're not close to anybody getting a retention bonus. So we need to make adjustments for the --

MR. PASTERICK: In terms of the incentive portion, we certainly intend to look at that and find out what it is. Whether we're -- first of all, whether we're rewarding the right things and setting realistic goals or if we're setting unrealistic goals.

AUDIENCE MEMBER: And those marketing incentives don't go into the register; correct?

MR. PASTERICK: No.

AUDIENCE MEMBER: So we have a little extra time, if needed, to work on them.

MR. PASTERICK: Let me make that clear. What goes into the federal register has to go through the proposed rule part. The proposed rule exercise and all that is the base allowance, the Best number, and a provision that says that a company can earn a maximum of two additional percentage points based on the achievement of certain marketing goals.

What the goals are, what we incentivize, what we reward, how you get that 2 percent is not in the register. And so we've got, you know, we're not constrained by having to finalize that in any particular time. We can wait until you sign the arrangement to do that.

AUDIENCE MEMBER: To assist with the discussion on the list, you had mentioned the pure premium and then compete on expenses. To deal with Bruce and Jack's issue, maybe we should add another one, for lack of a better name, actual expenses plus profit. We touched on that a little bit yesterday.

And a third one that we also started to touch on yesterday was to possibly add a category, either a broad category that we could break down for expense reimbursement for either ad hoc or new FIA requirements that come up each year. They may not be repetitive. They may be unique. Whether it's either the Monroe County issue, a major new effort in elevations, we have things that come up each year that the companies have raised concerns about having to absorb operating costs for.

Maybe another model would be to take the current model and add another category of unique FIA driven --

MR. PASTERICK: Maybe it's phrased bad, but that's really what we contemplated as number 5.

Just exactly what you described. Maybe that's not coming across.

AUDIENCE MEMBER: I don't read 5 that way at all.

MR. PASTERICK: Joe just described the way number 5 ought to read. That was really the idea that --

AUDIENCE MEMBER: We had discussed in the office before that 5 might be a menu-driven approach where they would simply pick above a baseline a certain number of other activities that we would have on the menu, such as certain marketing activities, training, education, et cetera, et cetera. And we would assign a cost element to each one of those, and then simply add up the totals of what the companies had selected on their own. What I just mentioned is different from that.

MR. PASTERICK: Okay. So 5 A and B. And I understand now the distinction you're making.

What Joe is really saying is that there would be a base level of service that the baseline expense allowance would reflect, and then there would be additional activities on which we would attach certain, for example training, that we would attach certain additional compensation to, but that the companies wouldn't have to choose to take on, if they decided not to.

So that would be 5 A. And then, of course, 5 B would be, in fact, basically where we are now, but some way of recognizing the additional costs associated with these kinds of -- let's just call them special projects that we pass on to the companies.

AUDIENCE MEMBER: One model that might be considered to be added to that is that perhaps that -- because otherwise, we'd have to plan a year in advance. You might be able to set up a pool, percentage pool, say 2 percent of the entire program could be allocated to the companies based on action plans that have been developed.

So maybe one year the particular additional action plans only create utilization of that special pool of 1 percent or half a percent or 2 or up to a certain amount. However, the plans that are created could not exceed what's kept in that pool so that you could do normal planning, but you would draw from that pool based on the work that is scheduled for that coming year. So you'll be drawing from the pool, either part of it or none of it, if there is nothing specific being created.

MR. PASTERICK: You're talking about the

special project kinds of things that wouldn't set aside a certain expense portion?

AUDIENCE MEMBER: And you use that based upon whatever action plans are unique.

MR. PASTERICK: And then there would be some basis for the company withdrawing from that pool depending on what they did to accomplish --

AUDIENCE MEMBER: I have a question on one of the things that Joe mentioned. He mentioned actual expenses plus profit. And my question was, did you have in mind with that something similar to the Florida homeowners JUA. The companies would submit a bid based on what their expenses would be to handle that, including their profit. And actually, if I remember correctly, there was a number -- you could have different payments to different companies, but they -- I think they established a threshold where they wouldn't go over, something like that.

I didn't know if that's what you were talking about, something like that.

AUDIENCE MEMBER: There are a number of ways to do it. I'm just throwing out the concept. It's not necessarily my idea, and it's come up before. And as long as we're throwing the concepts out --

MR. PASTERICK: Of course, that's

certainly a variation or fallout of the three- to five-year business plan that we would, in fact, be compensating companies individually based on their actual expenses.

The concept of actual expenses, of course, has been difficult for us because in this arena of antitrust and everything else, we're very reluctant to talk about that. So what we need to -- we need to be able to derive -- and we've collected some numbers that we can -- we can keep anonymous in terms -- see, there's really two ways of dealing with actual expenses. If we gather everybody's actual expenses and make them anonymous and just know that this is what it's costing the companies, then you either come up with some way of categorizing certain companies and say this group needs to compensate at this level or you end up with some kind of averaging. You know, and that's -- I think that's, in fact, one of the things we want to discuss today in our groupings.

And so anyway, Larry, you had a question.

AUDIENCE MEMBER: I just want to make sure I understand. No matter what we're talking about today regarding compensation to the companies, the cost to the consumer remains the same. We're not fiddling with the rates?

MR. PASTERICK: We're not -- well, one of the -- one of the alternatives would, in fact, affect the cost to the consumer. But that's something -- and that would be where we -- you wouldn't submit -- you wouldn't submit any of the expense dollars to us. You would establish what your expenses are and add that to the pure premium that we would set the rate for for claims and loss adjustment expenses and all that. And then you would set your expense figure.

That would impact -- that would result in a variation, a difference in costs to the consumer depending on what company -- again, I'm not suggesting that's the way we're going, but that is, in fact, one of the alternatives that we've kind of thrown on the table. That's kind of what Frank is talking about.

AUDIENCE MEMBER: I just think you ought to take it up with the management. It was a long time ago that we visited the idea that because of the federal nature of the program, every consumer would pay the same. But that's not the way you have a normal insurance program. Everybody doesn't pay the same for the same insurance product. Is there a way to feed that in? Are the companies feeling that maybe this is a time to take a look at that? If so, then you can work on mechanisms which allow the companies -- and, you know, the name of the game seems to be let the marketplace settle what the costs should be.

I'm just saying it's an option, but I think it's a more long-term option. I think it is an avenue to take a look at, and with the help of some people in your business who know the components that go into the expense figures, that go into the insurance expenses to say, you know, that doesn't account for special treatment of repetitive loss stuff, and, you know, we got rid of those.

But here we have to now give extra services for this. We have to give extra services with respect to trying to take care of elevation certificate problems. We may be able to develop a means of justifying some kind of a contingency loading for the, quote, federal nature of the program to meet some public policy goals, which is a little judicious.

MR. PASTERICK: We could just add that to the portion of the premium, and then the other expenses -- the other expenses would be individually determined by companies.

AUDIENCE MEMBER: It will probably be best answered in the break-out groups.

AUDIENCE MEMBER: I just had another observation. The insurance expense exhibit is trying to capture that. There's a wide range. I think the one thing everyone in this room would probably agree on is the average is not their company. They either were undercompensated or maybe some people who were overcompensated. Would it require a significant change if you just used individual companies' Best numbers?

AUDIENCE MEMBER: Then you're penalizing companies that are cost-effective.

AUDIENCE MEMBER: I don't know that that's necessarily true. I'm saying it costs us money to write product in Florida. There are companies that we compete against that have expenses similar to ours and those that have expenses greater and less than ours.

What we're trying to do is take something with a fixed price in various distribution systems and fit it all together. And it's never going to work. That's kind of my feeling. I wanted to say it out there.

AUDIENCE MEMBER: Just whatever realm

you consider, whatever alternative.

One of the things that we have, I think, collectively enjoyed from the outset is this hands-off look at cost and expense. In other words, over these last 15, 17 years, we have not had, and we've enjoyed the ability to not have the federal government in one form or another try to look behind and try to look at costs. And I think that served us extraordinarily well. And part of that is a reluctance on our part because it's a difficult thing to do.

But it's also been classically a reluctance on the company's part to say, Here, our books are open to you for this particular line. If we look to adjust it, the methodology, consider that as potential. Can we avoid it? Perhaps. I don't know. But I think it has to be considered as you look at the alternatives; that although these many years we have not had any requirement to get into that issue.

AUDIENCE MEMBER: In several of these alternatives, we've talked about possibly going to a competitive situation between companies. Have you looked at the legal ramifications of the possibility of this becoming now state regulated because of varying prices?

MR. PASTERICK: We would certainly be

putting at least a portion of what we're doing in the state arena. I don't think there's any question. I shouldn't say I don't think there's any question. I'm not a lawyer. But there's -- right now we have been able to stay above state regulation because of the way the program is structured.

To the extent that we're dealing in expenses that vary from company to company in several states and different companies operating within the same state with different expense numbers, the states are obviously going to be concerned about that.

AUDIENCE MEMBER: That would be a major disadvantage to the program.

MR. PASTERICK: I don't want to cut off discussion, and I'm not -- but I want you to start thinking. You know, we had the simple notion that we would have three or four of these things and break up in groups and you discuss this.

I'd like you to start thinking about some logical way that we can break up into three or four groups and maybe even -- because I think we've come to realize that some of these are probably ideally grouped together. There's no reason to break out separate groups to talk about, for example, 1 and 2 separately. 1 and 2 tend to be pretty much the same animal with a little bit of different coloration. Start thinking of some logical way to break them out.

The other -- and maybe this is one of the ways that -- maybe this is one of the breakdown points or break-outs. Not breakdown. Except nervous breakdown.

One of the break-out points is to have one group talk about what kinds of adjustments are feasible to be made for this coming arrangement year. And the same group actually could also talk about some longer-term kinds of alternatives too.

But then to have other groups talk about -- not worry so much about what we do this year because we did not rule out something for this year, as I said before, we just didn't want to close off the possibility of coming up with a significantly different compensation strategy. But to have the other groups talk about some possible longer term kinds of ways that we can construct, whether it be -- whether it be to recognize the individual company costs.

And maybe I'm thinking out loud to try to think how we could break up the groups. But to talk of some way of determining actual costs and go company by company. Maybe there is a way of grouping companies. I don't know.

We have big companies and small companies. There are economies of scale presumably, but there are overhead considerations. There are a lot of factors that feed into these things.

So anyway, I guess I'm trying to think through what might be a possible way to break this out. When I came up here, I thought we had a plan, but I don't want to be tied to -- the break-outs, according to these questions -- and I might suggest, and again, this is just a suggestion, that what I am seeing is there's a lot of other ways to do this other than the four or five that are listed on the sheet. And maybe the best way to approach it is have the groups or main groups and let's brainstorm. Let's not throw out any broad idea, but let's get a big list and then sort through the rest. And then let's look at the long-term solution and do the same thing.

AUDIENCE MEMBER: In my experience, I found that sometimes a stupid idea up front leads somebody to think of something and somebody else kind of builds on it and pretty soon you have a good idea.

MR. PASTERICK: What you're suggesting is maybe to break up in three or four groups, but don't distinguish? Have all the groups essentially the same?

How does that sound?

AUDIENCE MEMBER: In fact, I was raising my hand. You have about 50 people. Four groups of 12 or 13, and then at the end have a spokesman just come up and just present what their ideas are. And then from there, you can see what the consensus is for groups.

MR. CONNOR: The only thing I can say is, and I think we're on the same page on this, is on the short term, the short term should be the arrangement year coming up. And that addresses what Jack is talking about. Long term would be beyond, 2003 and beyond.

So when you do your brainstorming, and each group would have to do this, each group would look at short term being, What do we do for this upcoming arrangement year? Do we tweak here and there? What do we do now? We move into looking at some of the other alternatives that we need to look at as we go into the future. I think that's probably the way to do it. And then as someone suggested, have a spokesperson present it.

We got a lot of time to do this. We have all day to do this, and I think we can do it in that period of time.

AUDIENCE MEMBER: Can the short and long term end up the being the same?

MR. PASTERICK: It sure could.

AUDIENCE MEMBER: In any of this planning process, the parameters in which we have to work, for example, Item Number 1 says potentially adding one or two points. Is that feasible? And we need to know if we can add one. Can we add five? Ten? What's the pure premium?

MR. PASTERICK: Let me just say, as I've said over and over, whatever we come up with, we have to be able to defend, you know.

AUDIENCE MEMBER: What can you defend?

MR. PASTERICK: We can defend, well, we have some fairly solid data to substantiate. We can defend -- and Ed's been gathering some expense numbers from the various companies, and it looks like that it will support one or two. I think we can defend it.

But it has to be based on -- see, because, as I keep saying, for better or for worse it has served us, and maybe now it's penalizing us. Those Best numbers are out there, and it's something that we can hang our hat on now.

If what you're saying is we can't keep

hanging our hat on those numbers because they are not accurately reflecting our costs, then we need something we can at least hang our hat on. We'll defend it, believe me, but we have too much -- we can't -- and I don't want to oversimplify, but we can't say, The companies told us they need about five more percent and we kind of bought into that. Boy, we're dead if we do that.

AUDIENCE MEMBER: Can you defend your need for a profit?

MR. PASTERICK: Probably. I'm talking off the top of my head. We didn't build in profit before. And I talked to -- one of the people we wanted to get here was Dick Roth, but Dick is not traveling as much these days. And, you know, Dick recalls a day when there -- and as Frank recalls, there wasn't a profit built in there. Part of it was -- the benefit to the companies was viewed as other than financial profit. Companies to be able to provide full service. It was to keep the federal government out of the property insurance business as much as possible.

There were a number of benefits that were seen. But I think it is recognized that you're not in the social work business, and that one of the ways that we accomplish -- by using market forces, I think we've come around to the point. As a matter of fact, I want to think that the flood program has been a leader somewhat in using market forces to accomplish certain public kinds of objectives. We've got to recognize that those market forces, in fact, operate on the basis of making a profit.

AUDIENCE MEMBER: Based upon tomorrow's situation, my question would be, where would the preferred idea on the preferred concept go after tomorrow's reporting, after the long discussion that we will have on it today? So the question is, where will it go?

However, let me preface that by saying, based upon the fact that I guess just this sheet, and I'm speaking for our company individually and not for anybody else in this audience here, I received this last night. I checked with our company president to see if we had received anything prior to this meeting because probably I didn't get the word, which is not unusual. But I, for one, as a company person certainly am not ready, based on receiving this last night, to make any unilateral suggestions without any background and without any help from the people that -- my colleagues at the company.

So I don't know how many others here are in the same boat that I find myself. I'm not sure why the material derived here, which is a lot of work, if you're going to make a contribution to the meeting today, why it wasn't sent to us prior to yesterday.

So I guess with that, where would this preferred idea or preferred concept go tomorrow if it's reported by committee to you, sir?

MR. PASTERICK: Well, if I can break down, again, between the kind of short term and long term.

The short term, I think we have some sense of the territory, of where we are. And I think we can make -- we can have some discussions or proposals that I think we can give consideration to and have some discussions with the companies and come up with something in the immediate future.

In the long term, I don't think we ever anticipated that we would come out of this with any one single answer.

What I think this group -- what I would like to see come out of this group is to identify two or three possible long-term strategies that we should do further exploration. And that would be where we would have -- we would certainly need more data to be brought into it, but that we could then, through the flood committee, start working on some longer-term strategy on. If, in fact, it looks like some feasible long-term strategies that we can then go on, filter down into some serious decision with go, no-go kinds of points.

But that's not -- that wasn't what we anticipated for today. And you're right, we didn't send these out ahead of time because partly -- not because we didn't want to. That wasn't really the point. But because partly I think we wanted to use this as an opportunity to brainstorm.

We don't want to pass up this opportunity to take a look at the expense allowance and compensation in a way that we haven't done since 1983. Or '82 or whenever. This is really the most comprehensive or in-depth look that we've prepared to take at this in 17, 18 years.

And in terms of a long-term strategy, we had not anticipated we were going to come up with any final answer in two days. At the same time, I am very sensitive to Jack's point; that if there's any adjustments we can make for this year, to at least deal with some of the issues for this coming arrangement here, we could.

MR. LEIKIN: I just wanted to add that part of what we want to get out of this meeting here is to hear from you what the concerns are with various approaches. Not to make any final decision on this, but to know where we need to head over the next year.

MR. PASTERICK: And by the way, in the break-out groups, when you get to the long-term strategies, it's probably unrealistic for us to look into eight or ten possible long-term strategies.

It would be very helpful if at the end of this whole process, the group kind of -- there was some consensus that there were two or three or maybe four possible strategies that we ought to explore further. Then we can break those down in some way and maybe do some staffing of how those might work.

Realistically, that's probably as many as there are out there, but I don't know that we've got -- it could become an academic exercise if we throw out too many possibilities.

So I think part of your -- I guess part of the charge for the groups would be to have some prioritization of the longer-term strategies. Which ones should we be spending more time on? There's no use going down a road to explore some particular strategy that realistically maybe we figure there's not much there.

AUDIENCE MEMBER: Maybe in order to address Rhonda and Bruce and the other concerns, that if we did prepare the two lists, the short term and long term and the however-many categories, whether it's five, six, seven, just to get them down there. And then try and establish, assign some sort of a priority to whatever list each group develops.

Because of the concerns raised by some of the people this morning, if that winds up being the best we can accomplish, with two good lists with the pros and cons of each one, concerns of the companies of each one and what you all believe should be the priorities, then we can have those lists formalized so that then the folks who are here can take them back to their companies and discuss them with your senior executives as to the pros and cons. Which may differ from the pros and cons that come out of this meeting because your corporate executives may have very different ideas on some of these.

And also, as Rhonda said, it may trigger, by looking at some of the ones you all come up with, it may trigger some better alternative than if that's the approach that's taken. And then the comments come back from the companies to us where we can then try and reshape, to the extent that we may need to, depending upon the comments that would be sent back later, a couple weeks, what have you. And then make whatever that revised list would be the subject of discussions with the flood committee and so forth and so on.

And that's another approach to it which would address your concerns that you've got to discuss these things back in your home offices with your executives.

AUDIENCE MEMBER: You know, in addition to that, one of the quick ways in which you can prioritize this and you end up with a list of ten long-term goals. Use the collective wisdom of the group, and you go up to the board and check out the three that are most important to you. And then at the end, you see who voted the most for each ones using the collective wisdom of the group. That doesn't prevent you from going back, but it uses the collective thought process here in terms of what are the three most important.

MR. PASTERICK: And as you know, if we don't filter it down quite as precisely today and tomorrow as we would like to, we're going to be working with the flood committee. And they may be able to filter it down and refine it and to kind of get some sense of what we ought to explore.

Maybe we want to break it into four. How do we break it up?

At this point, and again, initially we were going to discuss different things in the different groups, but now that we're discussing basically having the same discussions, it's not as critical as to give --

AUDIENCE MEMBER: I think there should be an even mix of companies, but I think the company people should be spread out.

MR. PASTERICK: Let's go back to Jim's row because there's a lot of people bunched in back. So this is Group Number 1 from Wally back to Kevin and Jim Pitts here.

Behind him is Group Number 2.

Group Number 3 -- this is easy. Group Number 3 will go up to Dee's row. Dee is on the end. Dee and Joe.

And Group Number 4 is behind there.

That breaks it up. And as I say, you're all distributed fairly equally.

AUDIENCE MEMBER: I think there might be a need to have an FIA person in each group.

MR. PASTERICK: That's in general. You know, that's a general breakdown. If you want to make some adjustments, we're big people. We can handle that. This is not second grade.

Gather back here at 3.

(WHEREUPON, the proceedings adjourned at 3:45 p.m.)

C E R T I F I C A T E

STATE OF ARIZONA )
) ss.
COUNTY OF MARICOPA )

I, MICHAELA HERMAN DAVIS, a Certified Court Reporter, hereby certify that the foregoing pages, numbered 1 through 57, constitute a full, true and accurate transcription of all the proceedings had in the above matter, all done to the best of my skill and ability.

DATED at Phoenix, Arizona, this 8th day of February, 2001.

______________________________
Michaela Herman Davis, RPR-CRR
Certified Court Reporter
Certificate #50574