

# **SB 310**

## **Summary Report for the 78<sup>th</sup> Legislature**

### **Final Report**

**Prepared by:**

**Texas Department of Insurance  
March 28, 2003**

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## EXECUTIVE SUMMARY

### Key Points

- Insurance rates are determined by the sum of expected property losses, expenses, and profit targets. The largest of these components is property losses. Reductions in investment income have not had a large impact on rates.
- Rates in 2003 appear to be leveling off. Barring any further destabilization of the market, the Department anticipates this trend to continue on a broad scale, if not improve. Individual company rates, however, may behave differently than the norm.
- Individual company rates could be reduced anywhere from 0% to 25% from their current rates. Our analysis suggests that the companies reviewed are evenly distributed within this range. External parties have not reviewed our findings; discussion with industry, consumer groups, and independent reviewers may provide differing actuarial analysis.
- Our determination of how much rates might be excessive is based primarily on three factors: 1) loss trend assumptions; 2) target net rate of return, or profit, when calculating the premiums; and 3) accounting for coverage differences and the corresponding reduction in risk exposure.
- Upon a more comprehensive review and additional information, our revised estimate is that homeowners rates have increased statewide an average of 45% since 2000. A portion of the increase would have occurred under a rate-regulated market due to deterioration in experience, even in the absence of mold claims. The increase would have been at least 65% over 2000 without the Department's actions on increasing coverage options to allow flexibility in meeting consumers' needs.

- Rates for tenants (renters), condos, and dwelling fire (a policy similar to a homeowners policy without liability coverage) have gone up by 12%, 36% and 54% respectively since 2000.
- Credit scoring has had a significant impact on the rates charged individual policyholders within a company. With credit scoring, some policyholders will experience rate increases while others will see their rates go down. Overall, the company should collect the same amount of premium when credit scoring is used.
- Most companies did not include a provision for reinsurance costs in their calculation of rate level needs. For those that did, the provisions ranged from 2% to 9% which would increase rate levels by approximately the same amount.

## Summary

To address the concerns of the legislature this report contains a review of the rates, a determination of whether the rates are reasonable, and information pertaining to other items listed SB 310. Emphasis was placed on reviewing company rate levels and whether or not they were reasonable. Companies have taken substantial rate increases since 2000, resulting in an average statewide increase of 45% for homeowners. Rates have increased for tenants, condos and dwelling fire policies as well, by 12%, 36% and 54% respectively.

In 2002, companies began converting from the Commissioner promulgated forms to other policy forms providing less coverage. This means that policyholders are paying more for less coverage; however, overall rates would have gone up even if the changes in the coverage had occurred earlier. In addition, the expected rate of return that can reasonably be earned in the capital markets is lower than it has been in the past. However, companies continue to target rates of return which are much higher than is reasonably expected. This resulted in the use of unreasonable or excessive profit provisions being loaded into the rates. It is estimated that rates could be reduced from 0% to 25%.

Other factors which affect rates were also reviewed. The use of credit scoring can have a significant impact on premiums charged. Credit scoring was usually used in conjunction with other variables to determine an insureds tier placement. As such, it is difficult to determine how much of this range is solely contributed to by credit scoring alone. For example, for companies that used credit scoring as a rating variable (and not for tier placement) to provide discounts or surcharges, the rate within a single company could be increased 113% for the risks with the worst credit scores, as compared to risks with the best credit scores.

The premiums paid by insureds are also affected by any additional fees charged by the company or its agents. Companies provided information on policy fees, inspection fees, and installment fees. The first two can cost up to \$100 each. Installment fees were usually nominal, at \$2-\$5 per installment.

Companies' investments in securities and reinsurance costs were also reviewed as they are considered when rates are established. Although companies' investment returns on their assets are down, this has had minimal upward pressure on rate levels. Some companies include a provision for reinsurance in determining their rate levels. If a provision was used, it ranged from 2-9%, resulting in approximately the same upward effect on rates.

The issues reviewed are important aspects in the determination of rates. However, the assumptions made by the companies may have resulted in excessive rates being charged in the absence of any rate regulation. A system of rate regulation would, at a minimum, provide a system of checks and balances. Ideal rate regulation needs to consider rate standards, provide for the filing of

rates and supporting documentation, and be flexible enough to recognize the nuances and differences that exist in the market between companies.

## DISCUSSION

### Background

On February 25, 2003, Governor Perry signed SB 310 requiring rate information to be filed by certain insurers writing residential property insurance. The commissioner is required to prepare a summary report for submission to the 78<sup>th</sup> Legislature. Article 5.141 states that the report shall contain a review of the rates to inform the legislature as to whether the rates are just, adequate, reasonable and not excessive or unfairly discriminatory; and to assist in the determination of the most effective and efficient regulatory system for residential property insurance in Texas.

On February 26, 2003, Commissioner's Order No. 03-0128 (Order) was sent to 214 companies requesting certain information regarding their rates. Although the legislation only requires each insurer with a market share of 5% or more to file, it gives the commissioner discretion to ask companies with less than a 5% market share to respond.

The Order lists 22 insurers, representing the top 12 non rate-regulated insurers and 10 mid and small sized non rate-regulated insurers picked at random to provide more complete information. The insurers were required to submit their current rate manuals, supplementary rating information, actuarial support, underwriting guidelines, information on the use of credit scoring in rating and underwriting, policy and service fees, information on insurer's losses from investments, information on insurer's reinsurance costs, explanations of all computer models used as they relate to the current rates, and a six month outlook on rates. These 22 insurers comprise approximately 87% of the homeowners market.

The remaining 192 insurers listed in the Order were required to submit current rate manuals and underwriting guidelines, a six-month outlook on rates, information on policy and service fees, investments, and reinsurance costs as they relate to rates. If the company was withdrawing from the Texas market, or writing only commercial property insurance, they could file a notice to such extent without filing all the requested information. The total number of filings received was 62 as 152 companies filed such notices.

### Caveats

The findings and analysis below are based on information filed by the companies listed in the Order. The findings in this report are uncontested, as the insurers and other parties have not been provided an opportunity to respond. Discussion with industry, consumer groups, and independent reviewers may provide differing actuarial analysis. In addition, we have relied on the material submitted by the companies as is, without audit or verification to its accuracy. Our assessments

may be revised if additional relevant information is brought to our attention when the companies or other entities respond.

## **OVERVIEW OF THE MARKET**

### Rate Changes in the Last Three Years (An Update)

The Initial Report contained an exhibit that showed the average rate change taken since January 1, 2000 by the top 12 non rate-regulated companies. After reviewing the remaining filings, these numbers were revised. An updated Exhibit A (page 21) is attached. This exhibit shows what happened during this time by illustrating a theoretical \$1,000 premium on an HO-B policy in 2000. In 2001, rates increased on average, almost 5%, bringing the theoretical premium to \$1,049. In 2002, this figure would have been \$1,649, a 57% rate increase over 2001, and a 65% rate increase over 2000, had the Department not taken any action on policy form conversions.

During 2002, the Commissioner took a number of regulatory actions including modifying the previous HO-B form, which now excludes mold testing and remediation, but makes mold coverage optional. Companies adopted this change throughout 2002 and also began converting to approved national policy forms and to the HO-A form with company-filed enhancements. During the conversion process, companies generally reduced rates because of the limitation in coverage. This brought the theoretical rate from \$1,649 to \$1,426, a 13.5% reduction.

The change in coverage varies depending on the policy type that companies converted to. Estimates of the reduction in coverage range from 15% to nearly 45%, depending on what policy form the company converted to and the amount of coverage it provides. Exhibit A (page 21) denotes the change in coverage by the shaded area.

In 2003, rates have increased slightly from a theoretical \$1,426 to \$1,446, a 1.4% increase. Over the three year time frame, rates increased an average of 45%. The Initial Report estimated the increase at 38%; the change can be attributed to three items: 1) premiums used to weight the rate changes were updated from 2001 to 2002; 2) more companies were added; and 3) some of the rate changes had previously included tenants and condo rate changes.

Cumulative rate changes for tenants, condos and dwelling fire policies are shown in the table below. The rate changes are shown as a percentage from the rate levels effective January 1, 2000.



	<b>Tenants</b>	<b>Condos</b>	<b>Dwelling Fire</b>
1/1/2000 - 1/1/2001	0%	2%	6%
1/1/2000 - 1/1/2002	13%	13%	43%
1/1/2000 - 1/1/2003	17%	27%	54%
1/1/2000 – 3/31/2003	12%	36%	54%

Exhibits B, C and D (pages 22-24) illustrate the rate changes for tenants, condos and dwelling fire policies, respectively. No estimate has been made as to the amount of the reduction in coverage for these forms.

#### Changes in the Market

Though many of the major carriers are either not selling new policies or are limiting sales, several small companies are increasing their market share. Ten companies with over a million dollars in direct written premium (DWP) in 2001 substantially increased their books of business in 2002. These increases ranged from an increase of nearly double, to a twelve fold increase in DWP. Exhibit E (page 25) illustrates these changes. For comparison, Exhibit F (page 26) displays the DWP of the top 10 companies of 2002.

#### Six-month Outlook

Companies were asked to provide an outlook for the six months following February 26, 2003, including possible rate changes or changes to policy forms. While most companies simply replied that they had no changes planned, thirteen companies had substantive comments:

- Four companies mentioned items such as company rate indications or reinsurance costs that may lead to rate changes. Estimates ranged from a decrease of -10% to -15% to a possible increase of nearly +35%.
- Three companies plan to convert from the HO-B policy to an enhanced HO-A policy.
- Two companies are planning rate changes for their mold endorsements, while two others say that rate changes for endorsements are possible.
- Two companies recently implemented rate and/or policy changes in March while two others are planning rate increases for the summer.

#### Comparison of Premiums

Exhibits G and H (pages 27-30) are updates to the corresponding exhibits in the Initial Report. Additional companies, small and mid-size companies, have been included in determining the range of rates and the median rate. Rates for a few companies in the Initial Report were corrected and another was taken out as it is no longer writing homeowners.

The companies comprising the low and high ends of the ranges did not tend to change; however, the median rate is generally lower. This means the inclusion of

the small and mid-size companies' rates, while generally in the middle of the range, are towards the lower end.

Exhibit I (pages 31 and 32) provides similar information for tenants policies. It shows the current range of rates and the median rate being charged in different areas of the state. For each company, the actual rate that would be charged was reviewed for a given scenario (based on our calculations using the company's provided rating algorithm). We used a tenants policy for personal contents valued at \$25,000 with a 1% (\$250) deductible. Individual company rates are not shown in the report, but rather, a range of rates for each territory. These rates are based on the coverage most commonly provided today through the HO-BT.

The rates do not contemplate any discounts. Where insurers use credit scoring in rating to establish rating tiers within a company, the middle credit tier was used. Actual premiums charged may vary from the rates listed in Exhibits G, H and I based on company and policy forms offered. Other criteria, such as loss experience and credit score will also have an impact on the rates charged.

#### Effect of Discounts and Surcharges

In the Initial Report an example of how rates for individual insureds may increase more than the average was provided. Basically, some insureds receive discounts, causing their rates to change less than average, while other insureds are not eligible for discounts. Those not eligible for discounts receive rate changes greater than the average. Exhibit J (page 33) illustrates the effect of introducing new discounts (or expanding discounts). The changes and expansion of use in the age of home discount and credit scoring discounts have contributed to some of the rate increases felt by individual policyholders. The Initial Report stated that in theory, the combination of these two discounts, age of home and credit scoring, could lower rates by as much as 70% and increase rates by as much as 190% within an individual company. These figures also included the effect of tiering that may be due to factors in addition to credit history. For credit scoring alone, rates may be reduced from an "average" rate by as much as 27% or increased by as much as +75%.

Another way of looking at this is illustrated on Exhibit K (page 34). For the companies utilizing credit information in rating or tiering, rates can increase anywhere from 19% to 113%, depending on the company, for a person with poor credit compared to a person with excellent credit.

## **RATE LEVEL ANALYSIS**

### General

As stated in the Initial Report, our review of 12 individual company rate filings showed that rates could be reduced anywhere from 0% to 25% from their current levels, with some companies rates appearing justified at current levels. Those

with excessive rates appeared to be primarily the result of not accounting correctly for the lesser coverage being offered and assuming excessive loss trends.

With the opportunity to continue our review of the initial 12 companies and to review several additional middle and small size homeowners rate filings, our estimate on how much rates could be reduced has not changed. In addition, our analysis suggests that the companies are evenly distributed within this range. Our estimate that rates are excessive from 0% to 25% is based primarily on three factors:

- loss trends assumptions,
- target net rate of return, or profit, when calculating premiums, and
- accounting for coverage differences and the corresponding reduction in risk exposure.

A focused individual company review would look more closely at other components of the rate indications.

For tenants (renters), condos, and dwelling fire policies, the Department has not made a determination of appropriate rate levels. Companies generally took one of two approaches in establishing rates for tenants and condo forms- applied rate changes similar to homeowners, or made no significant rate changes. For dwelling fire policies, some companies calculated their rate level needs and took rate changes based on their analysis. We surmise that in these cases, since companies use the same methodologies and thought processes that they use for setting homeowners rates, the same issues we had with the homeowners rates would, transfer over to the dwelling fire rates.

An important consideration in the analysis is what would rates have done in the absence of the mold crisis? Industry studies suggest that rate levels in 2000 were inadequate. Had the mold crisis never existed, companies likely would have raised their rates at some point. Increases in underlying costs and anecdotal evidence that water losses excluding mold are increasing all contributed to an increase in rates.

#### Catastrophe Provisions and Models

Companies generally use a non-hurricane load and a hurricane load to provide a provision for catastrophes. Non-hurricane loads are usually determined by a long-term average ratio of non-hurricane catastrophe losses divided by the normal or non-hurricane, non-catastrophe losses. Hurricane loads are generally determined by the use of a stochastic model. Catastrophe models simulate the amount of expected losses that would be incurred in the event a hurricane makes landfall on Texas soil. The inputs to the models include the exposure distribution from the company as well as geographical and building cost data.

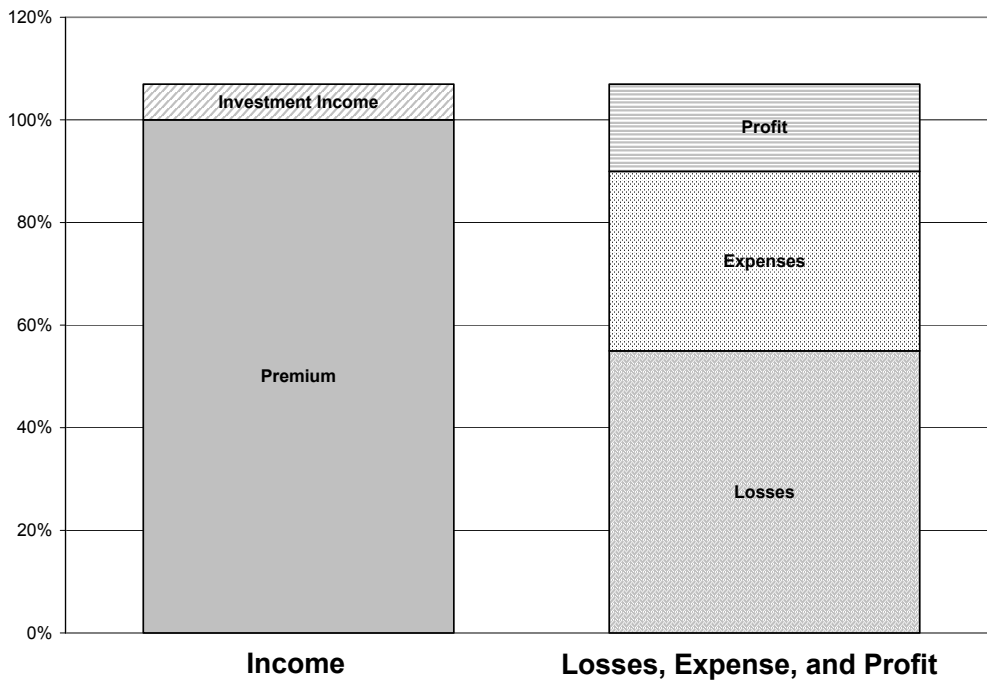
Companies using hurricane models generally consider the models proprietary. There are some companies that do not use a model to determine any portion of the catastrophe load. Each company’s methodology to account for the catastrophe exposure in Texas is slightly different. Rather than looking at catastrophe losses, some companies separate their losses into weather and non-weather losses, or wind and non-wind losses. The catastrophe loads used in the company rate level calculations not determined by the use of a model, were data driven, with little or no judgment used. In the review of companies’ rate levels, the catastrophe loads used by the companies have not been altered. In a more formal review of a company filing, the catastrophe loads would be more heavily scrutinized.

The models most widely used by the companies are AIR, RMS, EQECAT, and Catalyst. These models are considered proprietary and were not submitted.

Underwriting Profit Provision

The American Academy of Actuaries’ *Actuarial Standard of Practice No. 30* defines the underwriting profit as “premiums less losses, loss adjustment expenses, underwriting expenses, and policyholder dividends.” The total profit of an insurance company comes from underwriting profit and profit from reserves and surplus. The following chart shows the relationship between investment and profit.

**Relationship Between Investment Income and Profit**



The bars show that premium and investment income equal losses, expenses, and profit. The profit will be positive if the premium and investment income are

greater than the losses and expenses as shown in the chart. The profit will be negative if the premium and investment income are less than the losses and expenses.

The underwriting profit provisions used by the companies in establishing their current rates ranged from 0% to nearly 10%. As a comparison, the benchmark system in the late 1990's and early 2000's used a 1% profit provision. (The Initial Report erroneously stated that a -1% profit provision was used.) The amount of underwriting profit built into the rate levels is driven by the companies target after-tax rate of return.

A company's total after-tax rate of return on equity (cost of capital) is equal to underwriting income, investment income on reserves, and investment income on surplus. Exhibit L (page 35) shows historical rates of return on net worth (equity). Companies generally select their target total after tax rate of return and compute their investment income on reserves and surplus. Then, by formula, they calculate the underwriting profit provision needed to make up the difference. In the 1990s, companies could have negative or relatively small positive underwriting profit provisions and still obtain an adequate return on equity because interest rates were relatively high. A negative profit provision indicates that companies can earn enough from their investments to offset losses on their insurance operations. As investment income has declined over the last two years, companies can no longer operate profitably with a loss or minimal gain on their insurance business since there will be a smaller profit from investments to offset underwriting losses. As a result, a profit provision greater than the previously used 1% may be reasonable.

In prior benchmark rate proceedings, a reasonable cost of capital for the property and casualty insurance industry in Texas was determined to be 11.25% to 12.00%. The lower end of the range would apply to companies with less debt, or those that are not as highly leveraged. This range for the cost of capital produced a range of profit provisions that included the 1.0% mentioned earlier. Given that investment yields are down, the cost of capital is also down. The American Academy of Actuary's *Actuarial Standard of Practice No. 30* defines the cost of capital as "the rate of return that capital could be expected to earn in alternative investments of equivalent risk."

Recent information filed by the Office of Public Insurance Counsel and the industry for the private passenger auto and commercial auto benchmark rate hearings includes the cost of capital calculated by the parties ranging from about 8% to 11%. Depending upon a company's premium to surplus ratio and investment income, among other things, the resulting underwriting profit provision is likely to be in the range of 0-4%. Historically, the cost of capital for auto and homeowners has been the same in the benchmark rate hearings.

For the 22 companies that were required to submit their actuarial support, many of them selected a target cost of capital, or rate of return on equity, between 12% and nearly 20%. This means that the companies expect to make a net profit in this range. This is the companies' assumption of the opportunity cost on their capital. Given today's financial market, a target beyond 8% to 11% for cost of capital will result in underwriting profit provisions that are too high. The target rate of return on equity assumption contributes to the excessive rate levels that are being charged.

#### Investments in Securities

Companies filed information on insurer's losses from investments in securities, whether publicly or privately traded, including investments in the securities of companies required by any oversight agency to restate earnings within the 24 months preceding February 26, 2003, possessed and used by the insurer to determine premiums or underwriting for residential property insurance, as the information relates to the rates filed.

Many property and casualty companies have seen their investment income decline. However, the effect of the decline in the stock market is minimized because property casualty insurers tend to invest in bonds rather than stocks.

A publication by Moody's Investors Service titled, *P&C Insurers' Exposure to Deteriorating Credit Markets*, indicates that once adjusted for two insurers that skew the average, equity holdings in unaffiliated common stock represents less than 10% of the industry's total invested assets. *Best's Aggregates & Averages* provides similar information on the distribution of investable assets for private passenger auto and homeowners predominating companies. Exhibit M (page 36) shows the Best's information from 1991 through 2001. For the last few years, stocks have comprised approximately 23% of the investable assets for the private passenger auto and homeowners predominating companies. Based on information from *Best's Aggregates & Averages*, if the same adjustment is made for the two insurers that skew the average, the percentage of investments in stocks in 2001 is reduced from 21.6% to 9.7%.

In the sample of filings reviewed, company responses generally identified whether or not a capital gain or loss was realized on investments. Many companies reported capital gains but they were less than in prior years.

In addition, companies were asked to state whether losses on investment and reductions in interest rates affected their underwriting guidelines and their rates. In most cases, companies replied that these items did not have an affect on either their underwriting guidelines or their rates. In the other cases, companies provided a more detailed explanation of how losses on investments and reductions in interest rates affected their rate levels because assumptions on long term returns are reflected in their indications via the profit provision. Companies reflect the cost of capital through the underwriting profit provision in establishing

their rates. In general, a company's underwriting profit, investment income from insurance operations, and investment income on capital after income tax equals the target cost of capital. Companies select the target cost of capital and will look at their annual financial statements to determine the investment income from insurance operations and capital. With these variables as given, companies can then compute the underwriting profit they need in order to attain their target return on capital. An insurer's losses from investments in securities would be included in the investment income on capital. The impact on an insurer's overall rate needs is minor compared to other assumptions used in the calculation of rate needs.

One company commented that their "investment earning, excluding realized and unrealized capital gains, dropped by 0.4% from 2000 to 2001. This drop increased the underwriting profit provision by 0.6% to achieve the same target return on surplus." The company went on to say that the increase in the underwriting profit provision increased their rate levels by less than 1%. Similar results would be expected from the other companies.

#### Reinsurance Costs

Information on the insurers' costs of reinsurance both before and after September 11, 2001 as it related to the determination of premiums or underwriting guidelines was requested. Most companies replied that this information was not used in the determination of rates or underwriting guidelines. Other insurers provided information as to the costs of their reinsurance contracts and the provision used in the indications. In general, reinsurance costs increased after September 11, 2001. Most companies did not include a provision for reinsurance costs in their calculation of rate level needs. For those that did, the provisions ranged from 2-9%. A provision for reinsurance is an acceptable component of the expense provision, so long as the amount is justified.

### **ADDITIONAL TOPICS**

#### Use of Credit Scoring and Credit Scoring Models

The use of credit scoring in insurance is presently a subject of much interest. Currently, the use of credit scoring in rating is not permitted by companies subject to rate regulation. Lloyd's and reciprocal exchanges use it in the non rate-regulated market to rate policies or to slot insureds into specific rating tiers. The use of credit history in underwriting is a practice used by many of the companies, regardless of their rate regulatory status.

The models that are used to determine a risk's credit score encompass numerous variables, including:

- Credit inquiries
- Active or open credit accounts
- Balances

- Age of credit accounts
- Other time related items
- Number and time of delinquencies
- Number and age of derogatories (adverse public records)

The credit scoring models are essentially long and complicated mathematical formulas. Each variable (or sometimes a combination of variables) is multiplied by a numerical factor called a *coefficient*. These are then added to determine the credit score. Some *coefficients* are numerically positive (increase the credit score) and some are numerically negative (decrease the credit score). The following is a simple example, for illustration purposes only:

$$\begin{aligned} \text{Credit Score} = & \\ & (\text{Number of credit inquiries}) \times (\text{inquiry coefficient}) \\ & + (\text{Ratio of credit balances to available credit}) \times (\text{balance coefficient}) \\ & + (\text{Age of oldest credit account}) \times (\text{age of credit coefficient}) \\ & + (\text{Number of credit accounts more than 30 days delinquent}) \times \\ & (\text{delinquency coefficient}) \\ & + (\text{Number of collections}) \times (\text{collections coefficient}) \end{aligned}$$

Each model has a range of credit scores, for example 0 to 1,000. Based on the scores, insurance companies may then slot policyholders into rating groups based on increments of credit scores. For example, 0-99 might be one group, 100-199 another, etc. Each rating group may have a surcharge or discount applied to the insurance premium. For example, policyholders in the 200-299 group may be assigned a premium surcharge of 25% or offered a less favorable discount. Credit scores may also be used to decline coverage. For example, an insurance company may not offer coverage for any prospective policyholder with a credit score less than 200.

All insurers do not use credit models in the same way. For instance, an insured with a credit score in the 200-299 range may not be able to obtain insurance from one insurer but another insurer may insure him or her with a 25% surcharge (or not offer a discount). In addition, the number of credit rating groups and the amounts and ranges of surcharges or credits may vary from one carrier to another.

The following table shows how the companies are using credit scoring.

<b>Use of Credit History</b>	<b>Number of Companies</b>
Tiering	21
Rating Variable (Discount)	3
Underwriting	11
Not Used	27



While the use of credit scoring as a rating variable in the rate-regulated market has never been approved, insurer groups with more than one company could effectively use it to place risks into companies with different rate levels. This would be similar to using credit scoring to place risks into certain tiers within a single company, which the non rate-regulated companies do.

Companies using credit scoring as a rating variable or in tier selection can theoretically provide coverage to more risks because the rates charged will more accurately reflect the exposure to loss. The use of credit scoring as a rating variable, as well as any other discount offered, also allows companies to hold rates down for their preferred customers.

The non rate-regulated companies gain a competitive advantage over their rate-regulated counterparts in that they can offer lower rates to risks with good credit scores since the rate-regulated companies are essentially prohibited from using credit scoring in setting rates. If the average rate in a given territory is \$1,000, a non rate-regulated company could provide a discount of 20% for an insured with a good credit score. This would bring the rate down to \$800. The non rate-regulated company can charge another risk with a lower credit score \$1,200 to make up the difference. The rate-regulated company that can only charge \$1,000 will end up writing all the risks with low credit scores because they can get a better rate. The risks with the better credit scores will go to the non rate-regulated company. If the credit scores are predictive of future losses as studies indicate, then the rate-regulated company's underwriting results will deteriorate while the non rate-regulated company's underwriting results will improve. If the non rate-regulated company does not lower their rates for improved experience, they may retain an excessive underwriting profit. The rate-regulated company would have to raise their rates.

#### Underwriting Guidelines

For the purpose of Senate Bill 310, underwriting guidelines were reviewed in order to get a better understanding of the kinds of risks the different companies were writing which will have some relationship to the rates. There are several factors that are used in both underwriting and rating. Underwriting in the purest sense, is the determination of whether a company will accept or reject a risk. For example, an underwriting guideline may state that risks with 5 or more claims will not be written. Guidelines that affect the rate charged an individual would be rating rules or factors. For example, another company might take all risks with 5 or more claims but would charge them a higher rate based on the individuals claim history. Many companies utilize a tiering system where the best risks are given the lowest rate in an ultra-preferred tier or company, and the worst risks are given a higher rate in a standard tier or company. The number of claims, credit score, and home value associated with a given risk are often used to determine tier or company placement. The underwriting guidelines are used to help understand the rate structure.

An additional request that was made to the companies with 5% or more of the property insurance market (based on 2001 direct written premiums) was to provide actuarial support for underwriting guidelines, if they existed. In general, companies responded that underwriting guidelines are shaped by a myriad of factors. Loss experience, while one factor, is not the sole determinant of underwriting guidelines. Years of underwriting knowledge, business experience, market goals, growth, and probable maximum loss reduction efforts are some of the factors mentioned by the companies that help shape underwriting direction and are adjusted with changing market conditions.

### Policy Fees

The premiums paid by insureds are also affected by any additional fees charged by the company or its agents. Insurers were required to file their policy fees, service fees, and other fees charged under Article 21.35A or 21.35B. Article 21.35A provides that a local recording agent may charge a client a fee to reimburse the agent for costs incurred by the agent in obtaining a photograph of the property to be insured. The fee may not exceed the actual costs incurred by the agent. In addition, the local recording agent may charge a reasonable fee for services rendered to a client.

Article 21.35B provides that policy fees, agent fees, service fees, and inspection fees, among others, are allowed if solicited or collected in connection with an application for insurance.

The table below shows the type of fees and the range of fees that insurers reported to us in their submissions:

<b>Type of Fee</b>	<b>Range of Fees</b>	<b>Number of Companies</b>
Policy Fee	\$20 to \$75	10
Inspection Fee	\$25 to \$100	5
Installment Fee	\$2 to \$5	38

Installment fees are those charged if the insured pays his/her premium in installments throughout the policy period. For example, a homeowners policy covers one year, yet many insureds may desire to pay monthly or quarterly. To do so, companies may charge an installment fee.

Very minimal information was filed regarding agent fees. This could be because agents are not charging fees or the companies are not aware of the fees charged by the agents.

## **CONCLUSION**

To address the concerns of the legislature this report contains a review of the rates, a determination of whether the rates are reasonable, and information pertaining to other items listed SB 310. Emphasis was placed on reviewing company rate levels and whether or not they were reasonable. Companies have taken substantial rate increases since 2000, resulting in an average statewide increase of 45% for homeowners. Rates have increased for tenants, condos and dwelling fire policies as well, by 12%, 36% and 54% respectively.

In 2002, companies began converting from the Commissioner promulgated forms to other policy forms providing less coverage. This means that policyholders are paying more for less coverage; however, overall rates would have gone up even if the changes in the coverage had occurred earlier. In addition, the expected rate of return that can reasonably be earned in the capital markets is lower than it has been in the past. However, companies continued to target rates of return which are much higher than is reasonably expected. This resulted in the use of unreasonable or excessive profit provisions being loaded into the rates. It is estimated that rates could be reduced from 0% to 25%.

Other factors which affect rates were also reviewed. The use of credit scoring can have a significant impact on premiums charged. Credit scoring was usually used in conjunction with other variables to determine an insureds tier placement. As such, it is difficult to determine how much of this range is solely contributed to by credit scoring alone. For example, for companies that used credit scoring as a rating variable (and not for tier placement) to provide discounts or surcharges, the rate within a single company could be increased 113% for the risks with the worst credit scores, as compared to risks with the best credit scores.

The premiums paid by insureds are also affected by any additional fees charged by the company or its agents. Companies provided information on policy fees, inspection fees, and installment fees. The first two can cost up to \$100 each. Installment fees were usually nominal, at \$2-\$5 per installment.

Companies' investments in securities and reinsurance costs were also reviewed as they are considered when rates are established. Although companies' investment returns on their assets are down, this has had minimal upward pressure on rate levels. Some companies include a provision for reinsurance in determining their rate levels. If a provision was used, it ranged from 2-9%, resulting in approximately the same upward effect on rates.

The issues reviewed are important aspects in the determination of rates. However, the assumptions made by the companies may have resulted in excessive rates being charged in the absence of any rate regulation. A system of rate regulation would, at a minimum, provide a system of checks and balances. Ideal rate regulation needs to consider rate standards, provide for the filing of

rates and supporting documentation, and be flexible enough to recognize the nuances and differences that exist in the market between companies.

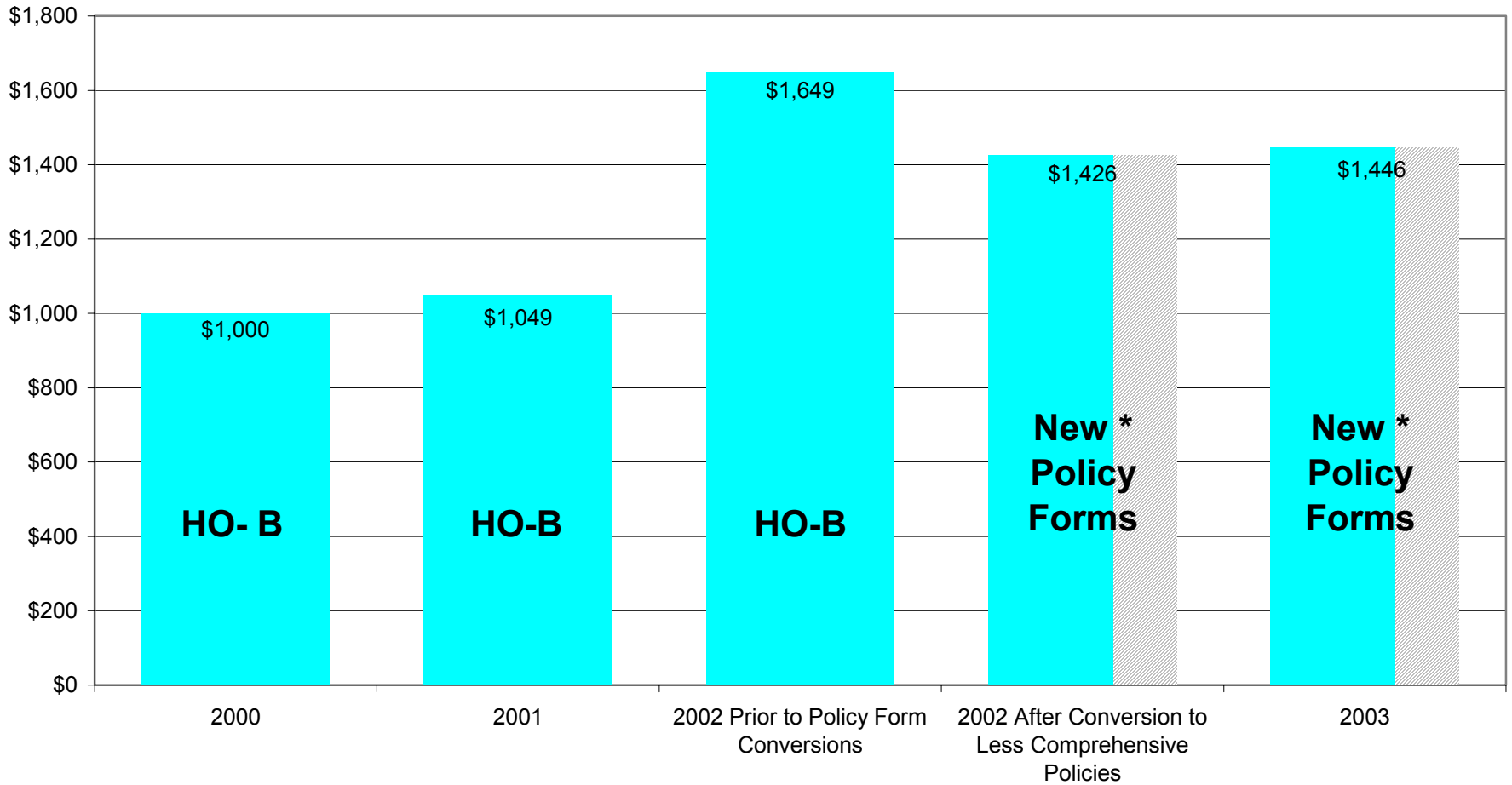
## Review of Key Points from Initial Report

### Key Points

- This report contains preliminary findings. A final report will be published by March 28, 2003. (*final report published March 28, 2003*)
- Individual company rates could be reduced anywhere from 0% to 25% from their current rates, with some company's rates justified at current levels.
- Where rates are excessive, it is primarily due to two factors: 1) companies not properly accounting for coverage differences and 2) using inappropriate loss trend assumptions. (*updated in final report*)
- External parties have not reviewed our findings; discussion with industry, consumer groups, and independent reviewers may provide differing actuarial analysis.
- Rates increased statewide an average of 38% since 2000. The increase would have been at least 56% over 2000 without the Department's actions on coverage forms. (*updated in final report*)
- Additional premium needed to offset discounts (the off-balance effect) contributed to higher rate increases for some policyholders within individual insurance companies.

## Relative Homeowner's Premium Levels

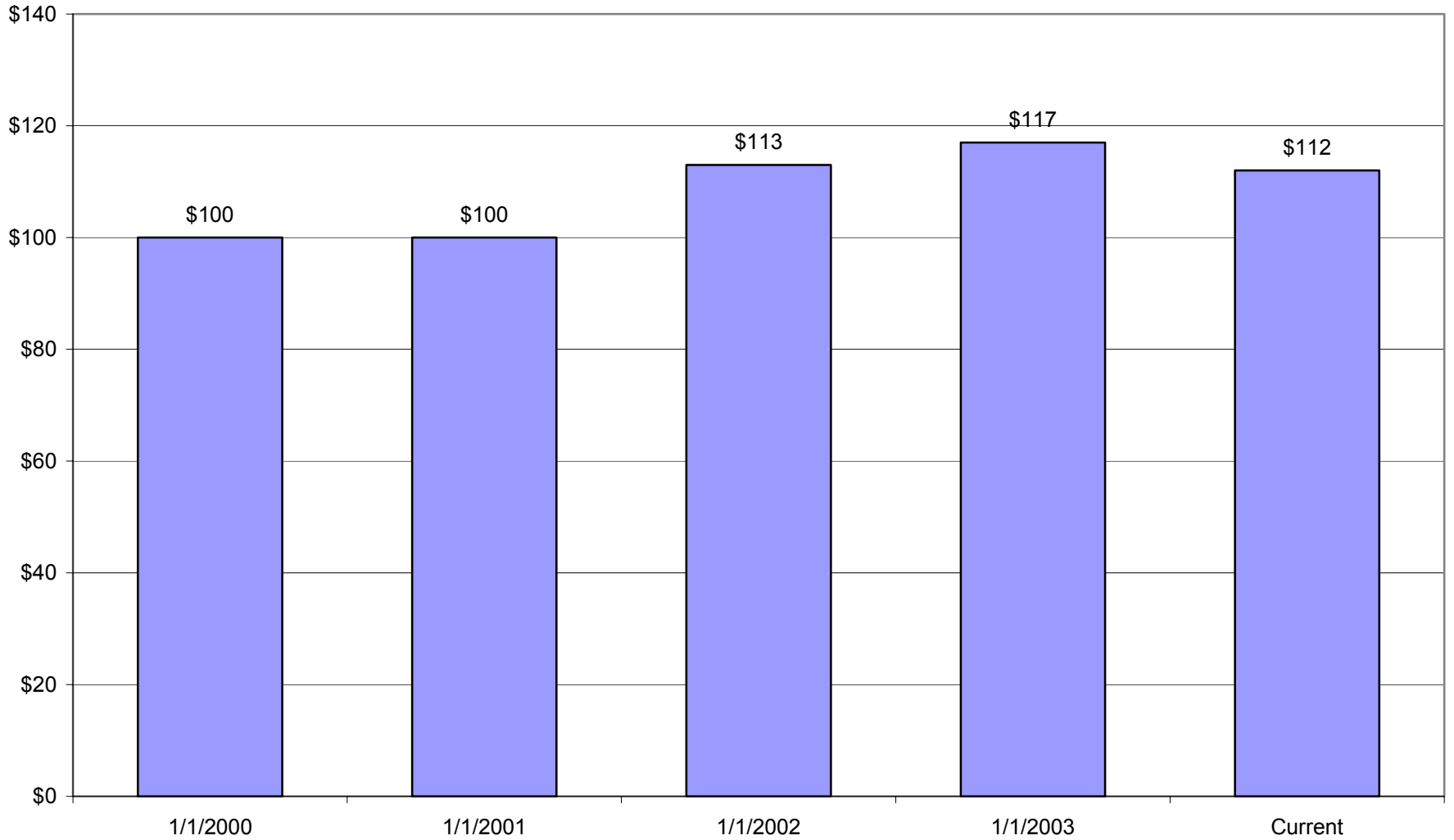
On An Average Basis per \$1,000 of Premium Paid as of 1/1/2000



\* Policies currently vary by company. They include enhanced versions of the HO-A, the state's minimum peril policy; various national forms that have been approved for use in Texas; as well as the traditional HO-B, the states most comprehensive form. Shading represents reduced coverage. Reduction in coverage will vary depending on policy. Various estimates of the reduction in coverage range from 15% to nearly 45%.

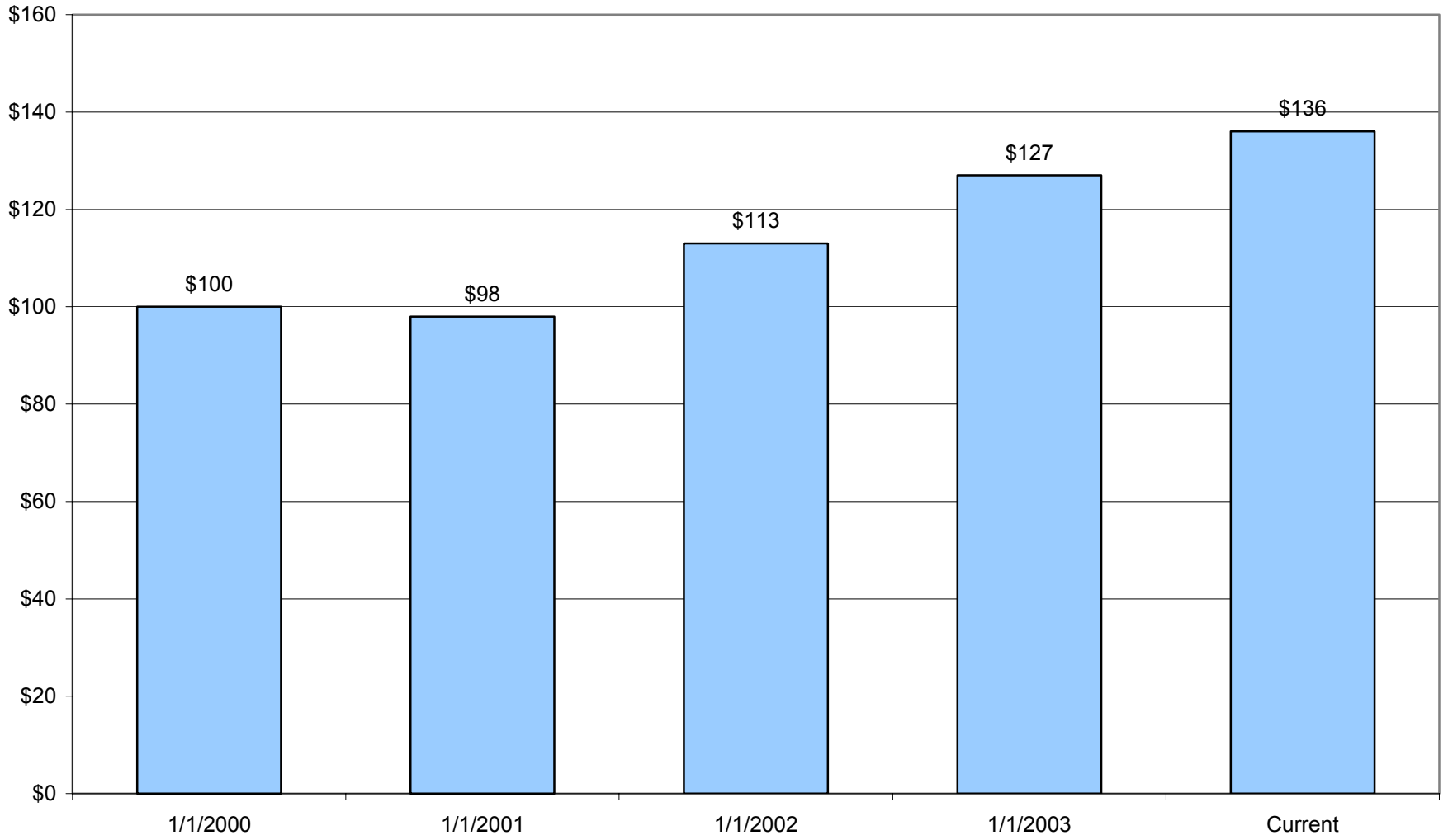
### Relative Tenants Premium Levels

On An Average Basis per \$100 of Premium Paid as of 1/1/2000



### Relative Condo Premium Levels

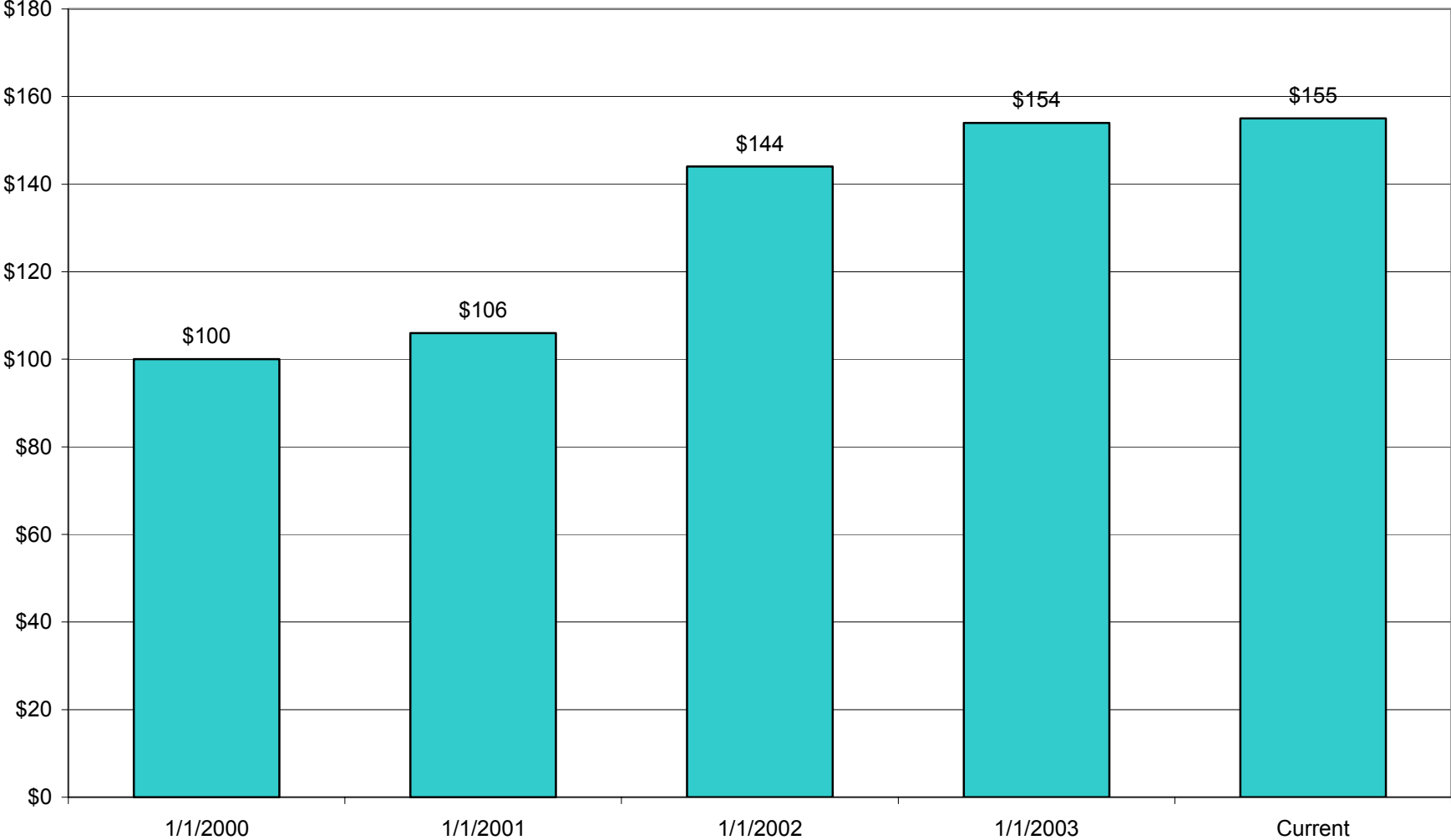
On An Average Basis per \$100 of Premium Paid as of 1/1/2000



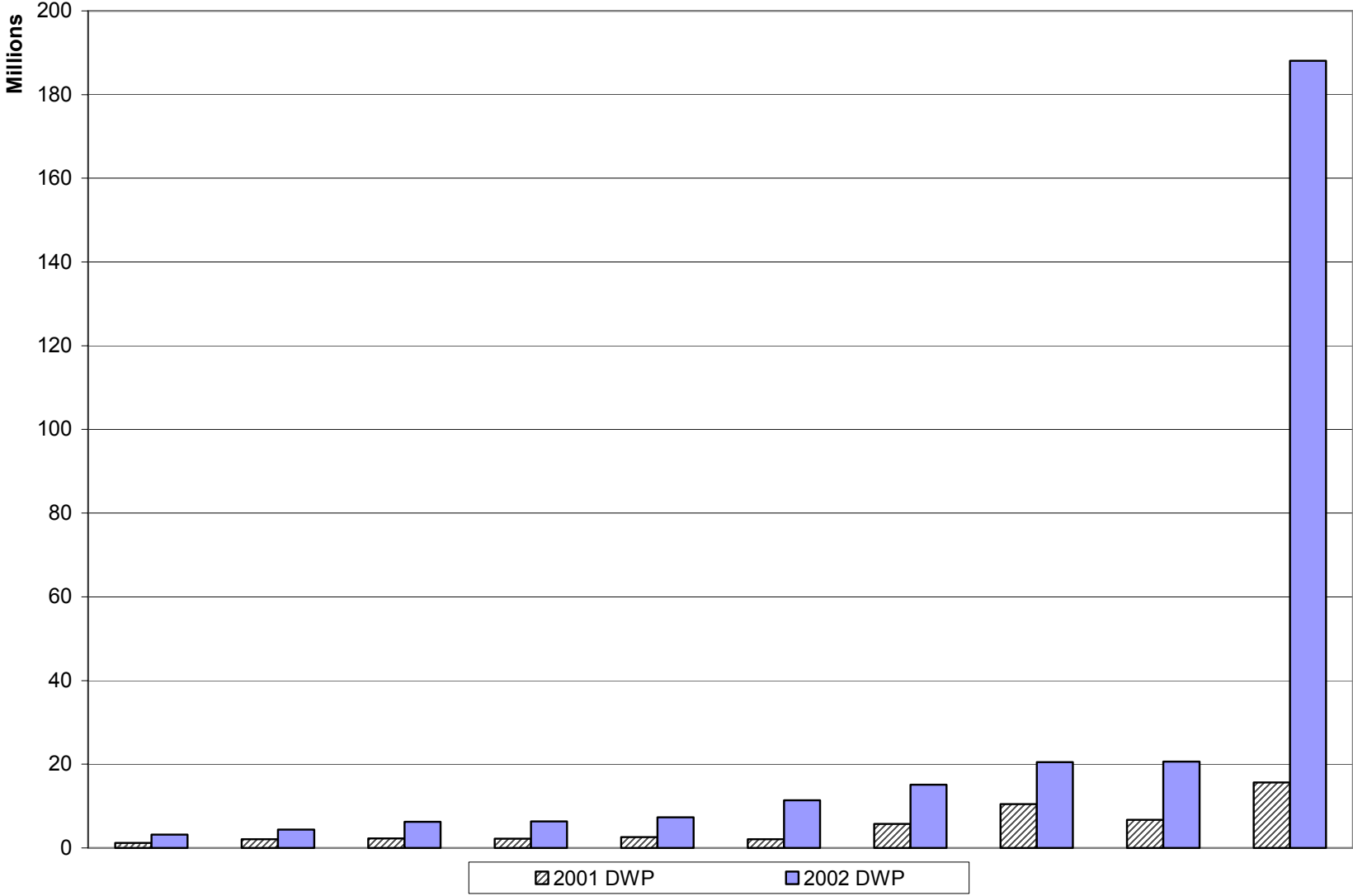


# Relative Dwelling Fire Policy Premium Levels

On An Average Basis per \$100 of Premium Paid as of 1/1/2000

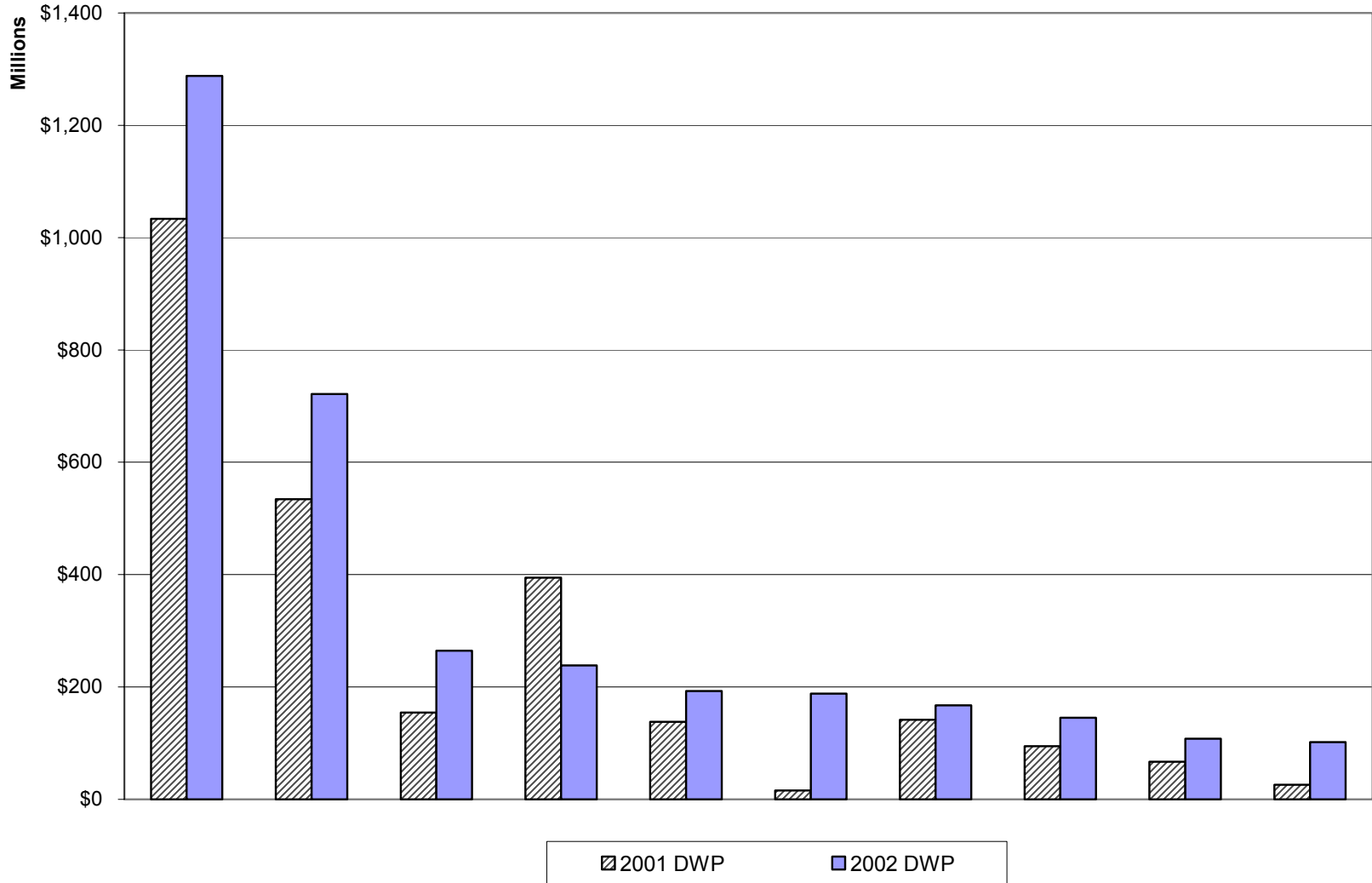


### Companies with Large Premium Growth in 2002 (each set of bars represents one company)



Source: Texas Statutory Page 14 of the NAIC Annual Statement for the Calendar Year Ending December 31, 2002

**Top 10 Home Insurance Carriers of 2002**  
 Direct Written Premium Volume - each set of bars represents one company

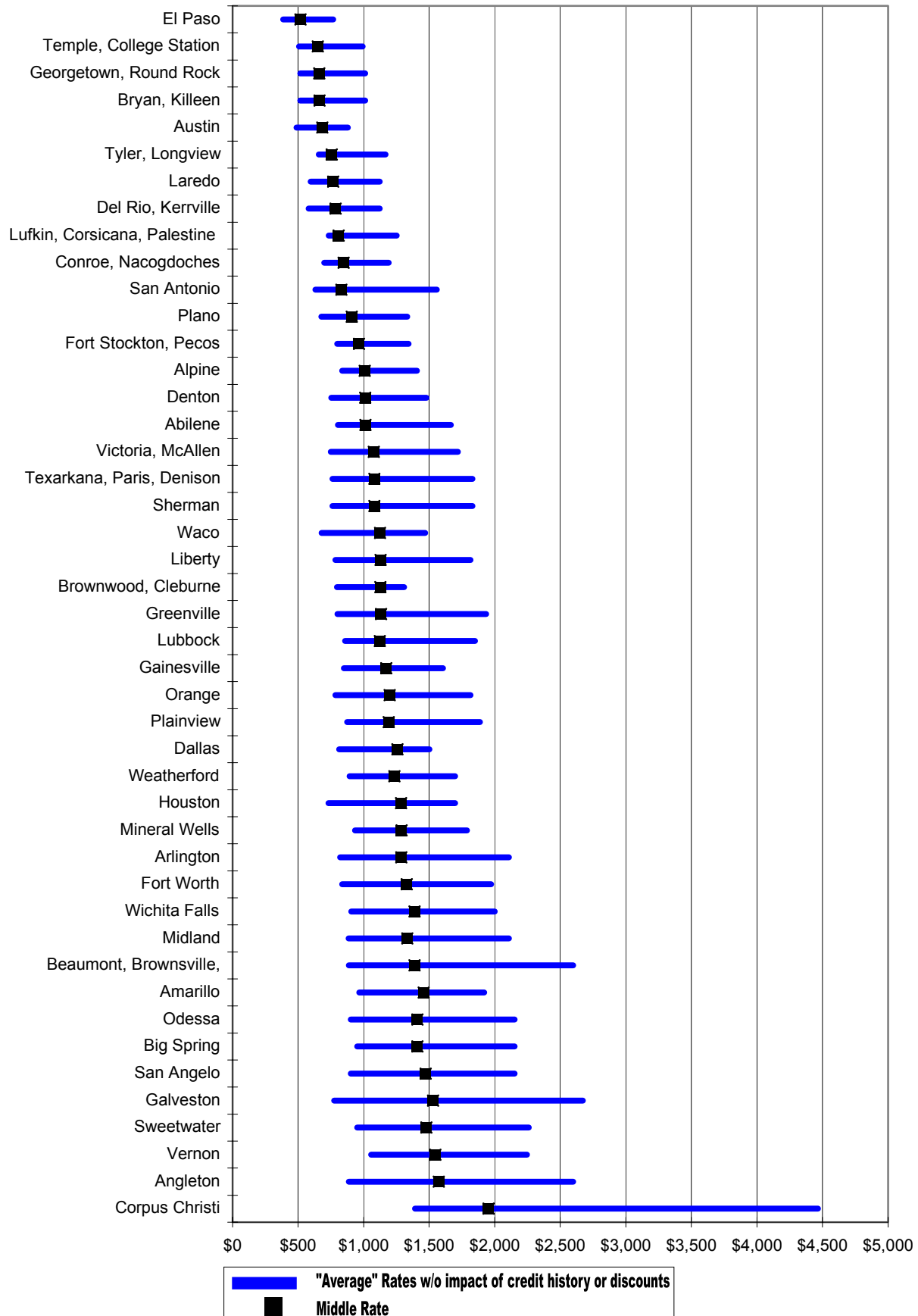


**Texas Homeowner Rates**  
**\$100,000 Coverage on a Brick-Veneer House, 1% Deductible**  
**Enhanced HO-A's and National Forms**

Rating Territory	Sample Cities	Industry Range*	Median*
1	Houston	\$730 - \$1,700	\$1,285
2	Dallas	\$815 - \$1,500	\$1,258
3	Fort Worth Arlington	\$835 - \$1,970 \$820 - \$2,105	\$1,328 \$1,288
4	Denton Plano	\$750 - \$1,480 \$675 - \$1,330	\$1,011 \$910
5	San Antonio	\$630 - \$1,555	\$831
6	Austin	\$490 - \$880	\$685
7	El Paso	\$385 - \$765	\$518
8	Galveston	\$775 - \$2,670	\$1,530
9	Corpus Christi	\$1,390 - \$4,465	\$1,952
10	Beaumont, Brownsville, Angleton	\$885 - \$2,600 \$885 - \$2,600	\$1,388 \$1,573
11	Orange Liberty Victoria, McAllen	\$785 - \$1,815 \$785 - \$1,815 \$750 - \$1,720	\$1,199 \$1,129 \$1,078
12	Laredo Del Rio, Kerrville	\$595 - \$1,120 \$580 - \$1,120	\$768 \$787
13	Bryan, Killeen Temple, College Station Georgetown, Round Rock	\$515 - \$1,010 \$505 - \$990 \$515 - \$1,010	\$663 \$650 \$662
14	Tyler, Longview Conroe, Nacogdoches Lufkin, Corsicana, Palestine	\$660 - \$1,165 \$700 - \$1,190 \$735 - \$1,250	\$757 \$847 \$810
15C	Fort Stockton, Pecos Alpine	\$795 - \$1,340 \$835 - \$1,405	\$965 \$1,008
15N	Midland Odessa Big Spring San Angelo Sweetwater	\$885 - \$2,110 \$900 - \$2,150 \$950 - \$2,150 \$900 - \$2,150 \$950 - \$2,260	\$1,333 \$1,411 \$1,411 \$1,472 \$1,478
16C	Brownwood, Cleburne	\$795 - \$1,310	\$1,127
16N	Abilene	\$805 - \$1,665	\$1,014
16S	Waco	\$680 - \$1,470	\$1,125
17	Texarkana, Paris, Denison Greenville Sherman	\$760 - \$1,830 \$800 - \$1,935 \$760 - \$1,830	\$1,082 \$1,132 \$1,082
18	Lubbock Plainview	\$860 - \$1,850 \$875 - \$1,885	\$1,122 \$1,190
19C	Weatherford Gainesville Mineral Wells	\$890 - \$1,695 \$850 - \$1,605 \$935 - \$1,790	\$1,235 \$1,172 \$1,289
19N	Wichita Falls Vernon	\$905 - \$2,000 \$1,055 - \$2,245	\$1,388 \$1,546
20	Amarillo	\$965 - \$1,920	\$1,457

\* Industry Range and Median are computed based on coverage most commonly provided today; an HO-A with enhancements and national forms. The rates for the broader all risk coverage forms, the HO-B, were excluded from this graph to provide a more apples to apples comparison. The National policies are base policies with no mold buybacks or optional additional water coverages.

### Texas Homowners Rates Illustration of Exhibit G

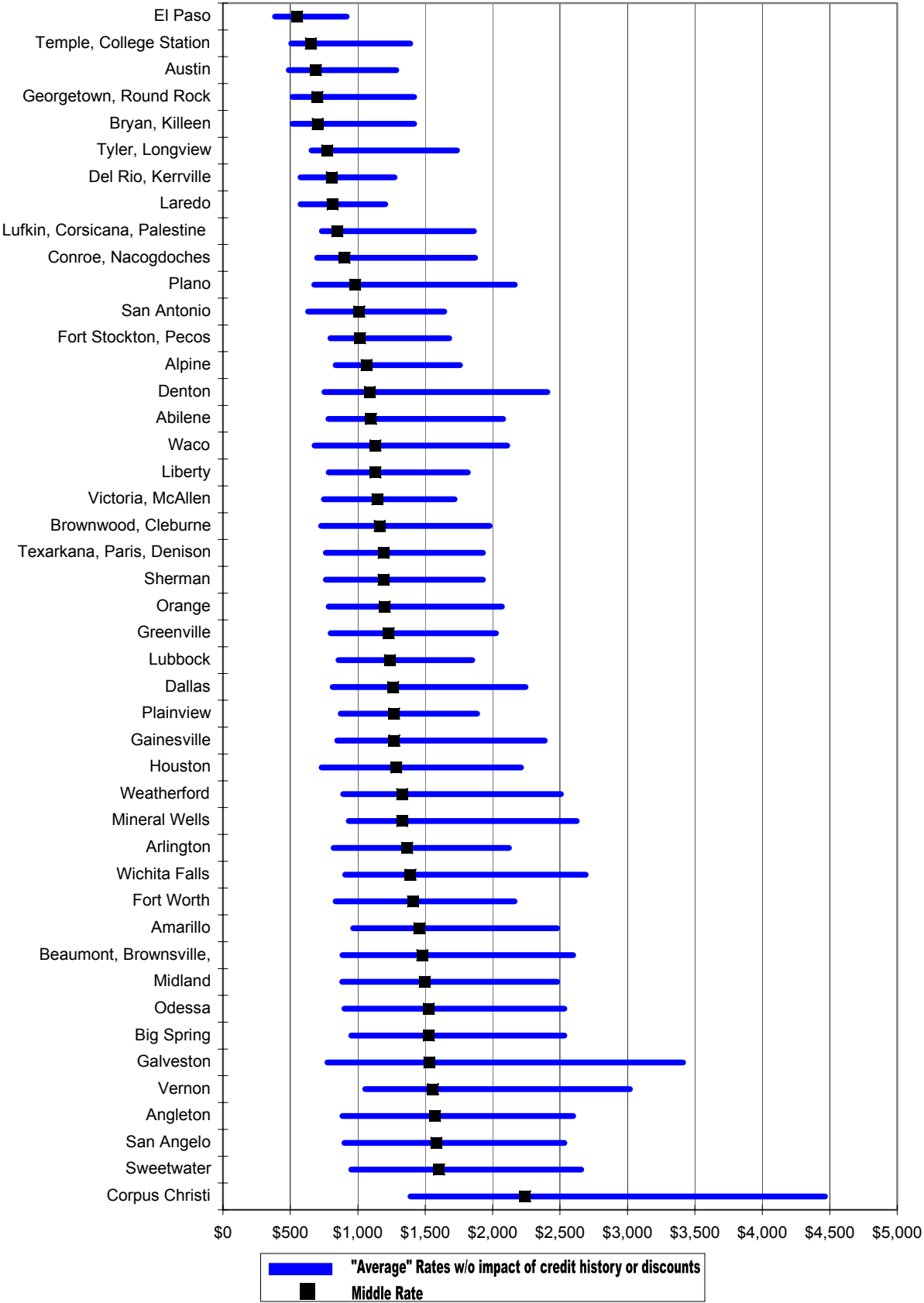


**Texas Homeowner Rates**  
**\$100,000 Coverage on a Brick-Veneer House, 1% Deductible**  
**Enhanced HO-A's, National Forms and HO-B's**

Rating Territory	Sample Cities	Industry Range*	Median*
1	Houston	\$730 - \$1,755	\$1,275
2	Dallas	\$815 - \$1,500	\$1,260
3	Fort Worth Arlington	\$835 - \$1,970 \$820 - \$2,105	\$1,402 \$1,336
4	Denton Plano	\$750 - \$1,260 \$675 - \$1,135	\$1,050 \$945
5	San Antonio	\$630 - \$1,555	\$967
6	Austin	\$490 - \$1,150	\$688
7	El Paso	\$385 - \$775	\$537
8	Galveston	\$775 - \$2,670	\$1,531
9	Corpus Christi	\$1,390 - \$4,465	\$2,200
10	Beaumont, Brownsville, Angleton	\$885 - \$2,600 \$885 - \$2,600	\$1,437 \$1,567
11	Orange Liberty Victoria, McAllen	\$785 - \$2,070 \$785 - \$1,815 \$750 - \$1,720	\$1,200 \$1,131 \$1,116
12	Laredo Del Rio, Kerrville	\$575 - \$1,205 \$575 - \$1,205	\$804 \$800
13	Bryan, Killeen Temple, College Station Georgetown, Round Rock	\$515 - \$1,010 \$505 - \$990 \$515 - \$1,010	\$685 \$652 \$684
14	Tyler, Longview Conroe, Nacogdoches Lufkin, Corsicana, Palestine	\$660 - \$1,165 \$700 - \$1,390 \$735 - \$1,250	\$773 \$875 \$837
15C	Fort Stockton, Pecos Alpine	\$795 - \$1,635 \$835 - \$1,715	\$999 \$1,047
15N	Midland Odessa Big Spring San Angelo Sweetwater	\$885 - \$2,480 \$900 - \$2,530 \$950 - \$2,530 \$900 - \$2,530 \$950 - \$2,660	\$1,470 \$1,527 \$1,527 \$1,555 \$1,601
16C	Brownwood, Cleburne	\$730 - \$1,965	\$1,144
16N	Abilene	\$785 - \$1,665	\$1,093
16S	Waco	\$680 - \$1,930	\$1,130
17	Texarkana, Paris, Denison Greenville Sherman	\$760 - \$1,830 \$800 - \$1,935 \$760 - \$1,830	\$1,141 \$1,188 \$1,141
18	Lubbock Plainview	\$860 - \$1,850 \$875 - \$1,885	\$1,219 \$1,266
19C	Weatherford Gainesville Mineral Wells	\$890 - \$2,505 \$850 - \$2,385 \$935 - \$2,625	\$1,303 \$1,224 \$1,311
19N	Wichita Falls Vernon	\$905 - \$2,045 \$1,055 - \$2,300	\$1,390 \$1,552
20	Amarillo	\$965 - \$2,240	\$1,446

\* Industry Range and Median are computed based on coverage most commonly provided today; an HO-A with enhancements and national forms, as well as, the rates for the broader all risk coverage forms, the HO-B. The National policies and HO-B's are base policies with no mold buybacks or optional additional water coverages.

### Texas Homeowners Rates Illustration of Exhibit H

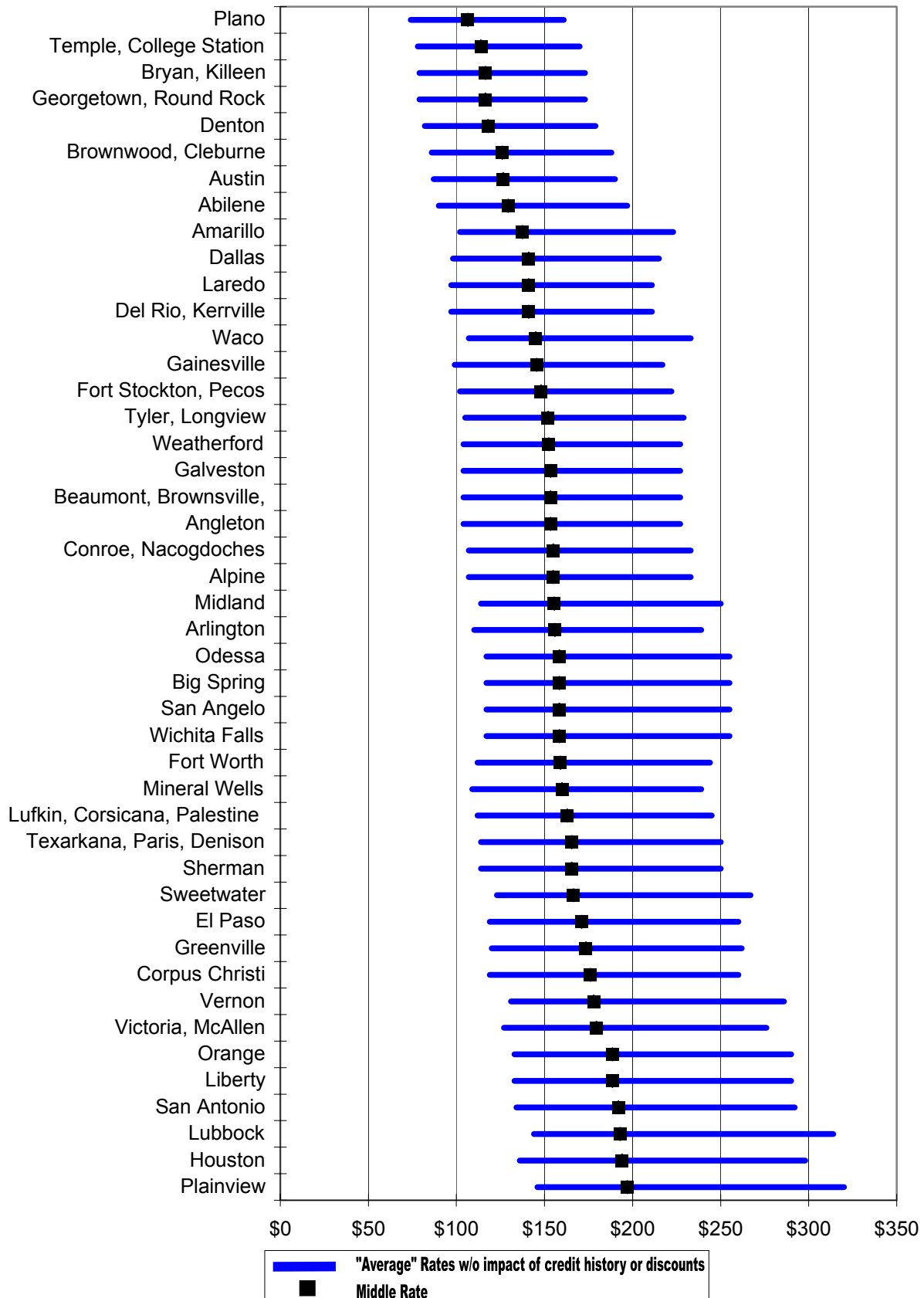


**Texas Tenant Rates**  
**\$25,000 Coverage on a Brick-Veneer Unit, \$250 Deductible**

<b>Rating Territory</b>	<b>Sample Cities</b>	<b>Industry Range*</b>	<b>Median*</b>
<b>1</b>	Houston	\$135 - \$300	\$194
<b>2</b>	Dallas	\$100 - \$215	\$141
<b>3</b>	Fort Worth	\$110 - \$245	\$159
	Arlington	\$110 - \$240	\$156
<b>4</b>	Denton	\$80 - \$180	\$118
	Plano	\$75 - \$160	\$107
<b>5</b>	San Antonio	\$135 - \$290	\$192
<b>6</b>	Austin	\$85 - \$190	\$127
<b>7</b>	El Paso	\$120 - \$260	\$171
<b>8</b>	Galveston	\$105 - \$225	\$154
<b>9</b>	Corpus Christi	\$120 - \$260	\$176
<b>10</b>	Beaumont, Brownsville, Angleton	\$105 - \$225 \$105 - \$225	\$154 \$154
	Orange Liberty Victoria, McAllen	\$135 - \$290 \$135 - \$290 \$125 - \$275	\$189 \$189 \$180
<b>12</b>	Laredo	\$95 - \$210	\$141
	Del Rio, Kerrville	\$95 - \$210	\$141
<b>13</b>	Bryan, Killeen	\$80 - \$175	\$117
	Temple, College Station	\$80 - \$170	\$114
	Georgetown, Round Rock	\$80 - \$175	\$117
<b>14</b>	Tyler, Longview	\$105 - \$230	\$152
	Conroe, Nacogdoches	\$105 - \$235	\$155
	Lufkin, Corsicana, Palestine	\$110 - \$245	\$163
<b>15C</b>	Fort Stockton, Pecos	\$100 - \$220	\$148
	Alpine	\$105 - \$235	\$155
<b>15N</b>	Midland	\$115 - \$250	\$156
	Odessa	\$115 - \$255	\$159
	Big Spring	\$115 - \$255	\$159
	San Angelo	\$115 - \$255	\$159
	Sweetwater	\$125 - \$265	\$167
<b>16C</b>	Brownwood, Cleburne	\$85 - \$190	\$126
<b>16N</b>	Abilene	\$90 - \$195	\$130
<b>16S</b>	Waco	\$105 - \$235	\$145
<b>17</b>	Texarkana, Paris, Denison	\$115 - \$250	\$166
	Greenville	\$120 - \$260	\$174
	Sherman	\$115 - \$250	\$166
<b>18</b>	Lubbock	\$145 - \$315	\$193
	Plainview	\$145 - \$320	\$197
<b>19C</b>	Weatherford	\$105 - \$225	\$153
	Gainesville	\$100 - \$215	\$146
	Mineral Wells	\$110 - \$240	\$160
<b>19N</b>	Wichita Falls	\$115 - \$255	\$159
	Vernon	\$130 - \$285	\$178
<b>20</b>	Amarillo	\$100 - \$225	\$138



### Texas Tenants Rates Illustration of Exhibit I



## The Effect of New Discounts on Premiums A Hypothetical Numerical Example

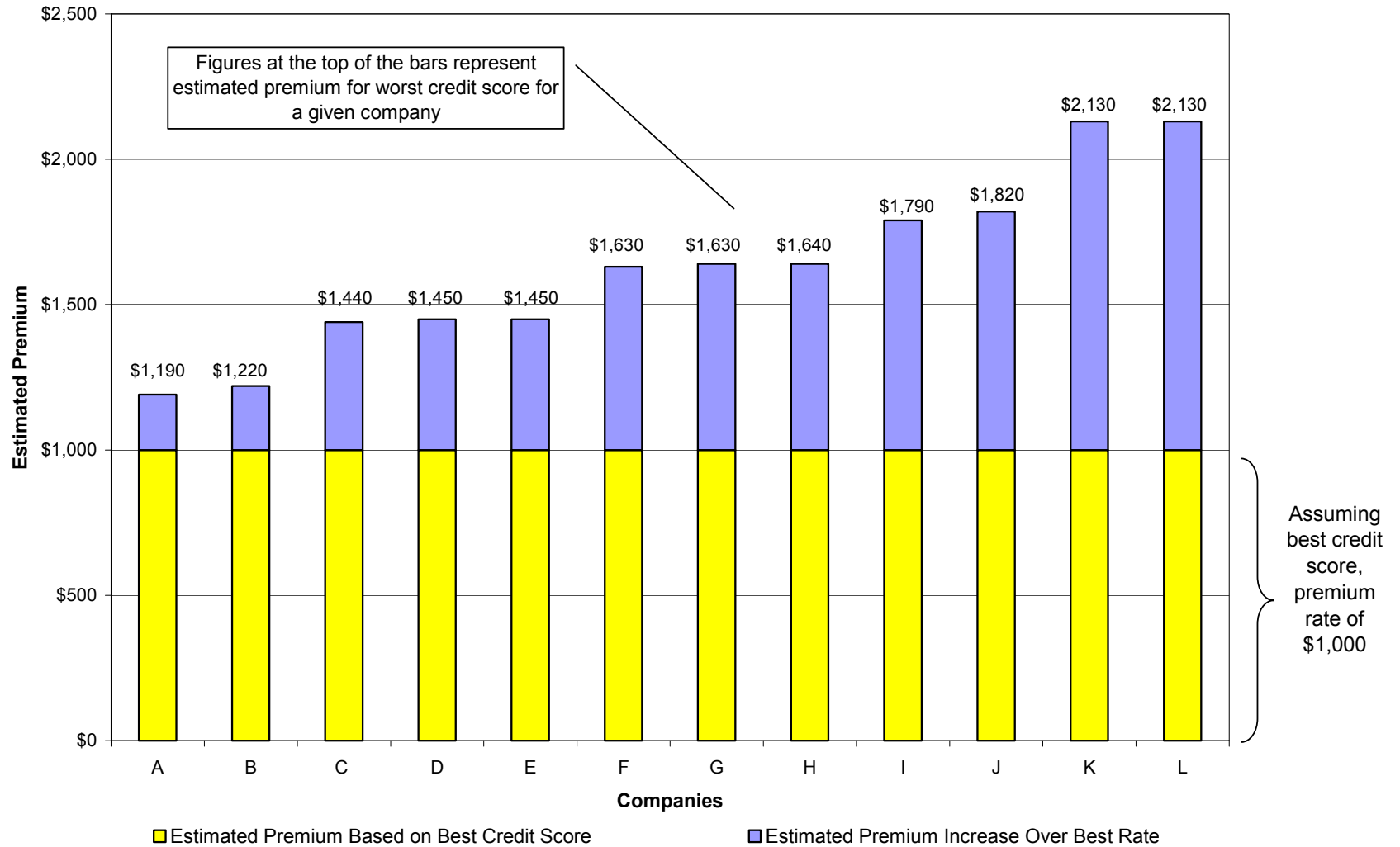
Example: An insurance company is thinking of implementing a new 40% discount. Two insureds with homes of similar value and coverage have a base premium of \$1,000 before the introduction of a new discount. Insured A would qualify for the discount but Insured B would not.

(1) <b>Insureds</b>	<b>Insured With</b>		<b>Total</b>	<b>Average Insured</b>
	<b>Discount</b>	<b>No Discount</b>		
	<b>A</b>	<b>B</b>		
(2) Original Before Discount Premium	\$1,000	\$1,000	\$2,000	\$1,000
(3) Percentage Discount to be Offered	40%	0%		20%
(4) After Discount Premium = (2) * [1-(3)]	\$600	\$1,000	\$1,600	
(5) Shortfall if base rates are not revised = (2) - (4)	\$400	\$0	\$400	
(6) Revised Base Rate = (avg(2)) / [1-(avg(3))]	\$1,250	\$1,250		
(7) Revised After Discount Premium = (6) * [1-(3)]	\$750	\$1,250	\$2,000	\$1,000
(8) Rate Impact = [(7) / (2)] - 1	-25%	25%		0%

With or without providing discounts, the total premium needed is still the same.

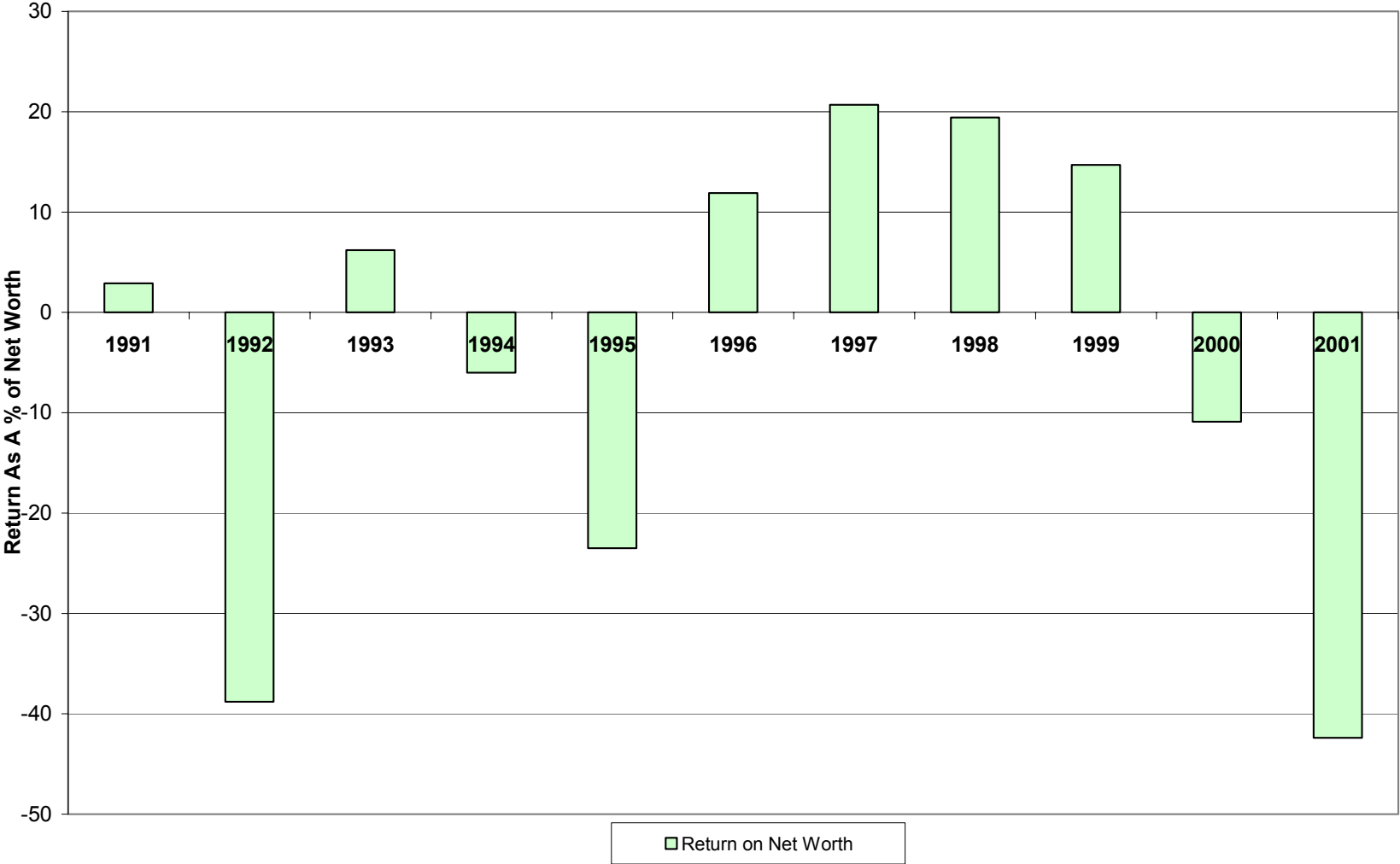
- In our example, Insured A receives the new discount and Insured B does not. The new discount is for 40% if an insured qualifies and 0% if they do not.
- Line (2) shows the premium that would be charged and collected before the new discount is offered.
- As we can see from line (5), in this hypothetical example, there would be a \$400 shortfall if the base rates are not revised.
- By revising the base rates to those shown in line (7), the total premium collected before the discount was adopted and after it was introduced are the same.

## Difference in Rates Due to the Use of Credit History for Given Companies



Note: Worst rates vary by company. Insureds with the worst credit history can pay between +19% and +113% more than insureds with the best credit history within a given company. This exhibit is based on the 12 Exhibit A companies using credit information for tiering or rating.

# TEXAS HOMEOWNERS HISTORICAL RATE OF RETURN ON NET WORTH



Source: Profitability by Line by State in 2001, NAIC

**SUMMARY OF INVESTABLE ASSETS DISTRIBUTION  
PRIVATE PASSENGER AUTO AND HOMEOWNERS PREDOMINATING COMPANIES**

Final Report for SB 310



Source: Bests Aggregates and Averages 2001-1992 Editions