IN THE MATTER OF	§	**BEFORE THE COMMISSIONER**
FARMERS INSURANCE EXCHANGE	§	**OF**
FIRE INSURANCE EXCHANGE	§	**INSURANCE**

APPLICATION FOR EMERGENCY CEASE AND DESIST ORDER

COMES NOW the Texas Department of Insurance ("TDI"), through Karen A.L. Barratt, Chief, Enforcement Section, Legal and Compliance, complaining of the Respondents: Farmers Insurance Exchange and Fire Insurance Exchange (referred to collectively hereinafter as "Farmers" or "Respondents"). TDI alleges that the Respondents are or have been engaging in unfair methods of competition or unfair acts or practices in the business of insurance in violation of TEX. INS. CODE ANN. art. 21.21 §§ 3 and 5 and 28 TEX. ADMIN. CODE §§ 21.1-21.5. Farmers is harming Texas consumers by overcharging for HO-A coverage. Pursuant to TEX. INS. CODE ANN. § 83.051, Farmers' conduct is causing or can be reasonably expected to cause public injury that is occurring or is likely to occur at any moment, is incapable of being repaired or rectified, and has or is likely to have influence or effect.

I. INTRODUCTION

1. TDI has been conducting an examination of Farmers' insurance practices and investigating complaints made by Farmers' policyholders. When TDI's examination revealed that Farmers had engaged in discriminatory conduct, it referred that matter to the Office of the Attorney General. The Consumer Protection Division of the Attorney General's Office had also been investigating Farmers' failures to disclose material information about its insurance practices. The Attorney General has independent authority under TEX. INS. CODE ANN. art.

21.21 § 15 to bring an action for violations of art. 21.21 and § 17.46 of the Business and Commerce Code. The Attorney General filed suit against Farmers based on these deceptive practices pursuant to that authority and included claims based on TDI's referral concerning Farmers' discriminatory practices. TDI's investigation, however, continued and has led to information that Farmers is harming Texas consumers by utilizing unsound and unjustifiable practices in calculating the premiums charged by Farmers for HO-A coverage. These allegations are distinct from the allegations already brought by the Attorney General.

2. The focus of this Application is the unfair practices which Farmers uses in determining the amount of premiums to charge. The Commissioner has specific authority under TEX. INS. CODE ANN. art. 21.21 §§ 3 and 5 to determine what constitutes an unfair practice in the business of insurance. Pursuant to TEX. INS. CODE ANN. § 83.004 the Commissioner may proceed with an emergency cease and desist order in conjunction with other applicable law. Because the actuarial justification for Farmers' premium-setting practices is at issue in this Application and that issue is within the special competence of this agency, it is appropriate to bring the Application separately in conjunction with the action filed by the Attorney General to enable the Commissioner to make a determination as to whether the manner in which Farmers' determines the premiums it will charge is an unfair practice in the business of insurance.

II. RESPONDENTS AND SERVICE

3. Farmers Insurance Exchange is a foreign insurance carrier organized and existing under the laws of California and authorized to conduct a homeowners insurance business in Texas. Its principal place of business is 4680 Wilshire Boulevard, Los Angeles, California 90010 and it

may be served with process by serving its agent for service, Gerard Galvan, Farmers Insurance Exchange, 1000 Farmers Circle, Round Rock, Texas 78728.

4. Fire Insurance Exchange is a foreign insurance carrier organized and existing under the laws of California and authorized to conduct a homeowners insurance business in Texas. Its principal place of business is 4680 Wilshire Boulevard, Los Angeles, California 90010 and it may be served with process by serving its agent for service, Fred B. Werkenthin, Jackson, Walker, L.L.P., 100 Congress Avenue, Suite 1100, Austin, Texas 78768.

III. JURISDICTION

5. The Commissioner of Insurance ("Commissioner") has authority and jurisdiction over this matter pursuant to TEX. INS. CODE ANN. §§ 83.002 and 83.051 and arts. 19.01-19.13, 21.21 and 28 TEX. ADMIN. CODE §§ 1.901, 21.1-21.5, and TEX. GOV'T CODE ANN. §§ 2001.051-2001.178.

IV. NATURE OF THIS ACTION

6. This application for an emergency cease and desist order is brought by the Enforcement Section, Legal and Compliance Division of the Texas Department of Insurance for the purpose of obtaining an ex parte cease and desist order, without notice or hearing, under the authority of TEX. INS. CODE ANN. §§ 83.002 and 83.051 and 28 TEX. ADMIN. CODE § 1.901. If granted, Farmers Insurance Exchange and Fire Insurance Exchange and all of their agents, employees, and/or representatives will be ordered, pursuant to TEX. INS. CODE ANN. § 83.051 and 28 TEX. ADMIN. CODE § 1.901, to cease and desist from engaging in activity within this

State which constitutes unfair methods of competition or unfair acts or practices in the business of insurance by unfairly overcharging Texas policyholders for HO-A coverage.

V. ALLEGATIONS

7. The Enforcement Section, Legal and Compliance Division of TDI shows as follows:

Commissioner's Authority

8. The Legislature has established a rate regulation system for certain lines of insurance. TEX. INS. CODE ANN. art. 5.101. This system, known as the "flexible rating system," allows the Commissioner to establish benchmark rates for homeowners insurance in Texas. Insurers then determine their rates through the application of flexibility bands to the benchmark rate. Insurers are required to file rate increases or decreases with TDI; but as long as the rate increases or decreases are within the flex band the Commissioner's prior approval of the rates is not required. TEX. INS. CODE ANN. art. 5.101 § 3(e). The rates must be just, reasonable, adequate and not excessive for the risks to which they apply. *Id.*

9. Reciprocal exchanges such as Farmers are exempt from the operation of all insurance laws in this state except as specifically provided in Chapter 19 of the Insurance Code or unless other insurance laws are specifically made to apply to them. TEX. INS. CODE ANN. art. 19.12(a). As a reciprocal exchange, Farmers' homeowners insurance rates are not subject to the flexibility bands and rate limitations established by the Commissioner under article 5.101 of the Insurance Code. TEX. INS. CODE ANN. art. 19.12(a). Accordingly, Farmers need not, and in fact, does not, file its homeowners insurance rates with TDI. The Commissioner does not review Farmers' homeowners insurance rates prior to use.

Insurance Code, Article 21.21, Sections 3 and 5

10. Although Farmers' homeowners insurance rates are not subject to review prior to use, Farmers may not engage in unfair methods of competition or unfair practices. The Legislature has deemed that reciprocal exchanges, such as Farmers, are not exempt from and are subject to article 21.21 of the Insurance Code. TEX. INS. CODE ANN. art. 19.12(b)(2). Article 21.21 regulates trade practices in the business of insurance by prohibiting unfair methods of competition or unfair acts or practices. TEX. INS. CODE ANN. art. 21.21 § 3. Article 21.21 defines certain prohibited trade practices in the business of insurance. Article 21.21 also allows the Commissioner to determine that other trade practices of any person engaged in the business of insurance in Texas constitute unfair methods of competition or unfair acts or practices in the business of insurance. TEX. INS. CODE ANN. art. 21.21 §§ 3 and 5. Furthermore, the Legislature has deemed that article 21.21 shall be liberally construed and applied to promote its underlying purposes. TEX. INS. CODE ANN. art. 21.21 § 1(b). Therefore, the Legislature has granted the Commissioner specific authority, pursuant to TEX. INS. CODE ANN. arts. 19.12(b)(2) and 21.21 §§ 3 and 5, to determine that reciprocal exchanges such as Farmers are or have been engaging in an unfair method of competition or an unfair practice in the business of insurance in Texas even though the act or practice is not defined as such in TEX. INS. CODE ANN. art. 21.21 § 4 or 28 TEX. ADMIN. CODE §§ 21.1-21.5.

Insurance Code, Ex Parte Cease and Desist Orders

11. The Insurance Code authorizes the Commissioner ex parte to issue an emergency cease and desist order against an authorized person engaging in the business of insurance provided certain criteria are met. TEX. INS. CODE ANN. § 83.051(a)(1)(A). That authority specifically

extends to reciprocal exchanges such as Farmers. TEX. INS. CODE ANN. § 83.002(a)(5). Furthermore, the Commissioner may proceed solely under Chapter 83 of the Insurance Code or under Chapter 83 in conjunction with other applicable law. TEX. INS. CODE ANN. § 83.004.

HO-B Policies and HO-A Policies

12. Texas has had some of the highest homeowners rates in the country. This is partly due to the coverage provided by the HO-B (sometimes referred to as "comprehensive" or "standard" coverage), which used to be the most commonly sold homeowners policy in Texas. The HO-B, previously written for 96 percent of policyholders industry wide, provides broad coverage, hence, one reason for the higher cost. The HO-B provides "all risks" coverage for the dwelling, meaning unless the cause of loss is specifically excluded, it is covered. Personal property is covered for named perils. A loss to the dwelling is settled on a replacement cost basis. A loss to personal property is settled on an actual cash value basis, however, replacement cost coverage is available by endorsement. The HO-B includes coverage for mold if contamination ensues from an otherwise covered loss, such as a roof leak or plumbing.

13. The HO-A provides "named peril" coverage for the dwelling and personal property, meaning the actual cause of loss must be from a specifically named peril, such as fire, lightning, windstorm, hurricane and hail, explosion, aircraft and vehicles, riot and civil commotion and theft. Losses are settled on an actual cash value basis ("ACV"). ACV is replacement cost minus depreciation.

14. Therefore, between the HO-B and the HO-A, the HO-A is more limited, offering less coverage than the HO-B. The HO-A provides only very limited coverage for water damage and

losses involving mold. This is a highly significant factor when considering whether Farmers' Texas HO-A rates are unfair.

Mold Water-Related Claims

15. Beginning in 2000, the home insurance market in Texas saw a dramatic increase in mold claims. TDI determined that the number of mold water-related claims against the three largest residential property insurers (which includes Farmers) rose more than 500 percent within an 18-month period (January 1, 2000-June 30, 2001).

16. To address the growing crisis of homeowners insurance availability and affordability, the Commissioner held four public hearings in three cities in the summer and fall of 2001 to obtain input from the broadest possible spectrum of persons regarding problems with mold. On November 28, 2001, following publication of a Staff proposal, the Commissioner adopted amendments to residential property policies, including the HO-B. The modified HO-B policy retains basic coverage of ensuing mold related to certain causes of water damage. The basic coverage eliminates coverage for high priced procedures, such as testing, treating, containing or disposing of mold beyond that which is necessary to repair or replace property that is physically damaged by water. This is a significant change in coverage. Companies have until December 31, 2002 to comply with Commissioner's Order No. 01-1105.

Commissioner's Instructions to Staff

17. On or about December 2001, the Commissioner instructed TDI staff ("Staff") to examine the conduct, performance, and practices of the three largest writers of homeowners insurance in Texas, including Farmers, in connection with homeowners insurance in Texas. The Commissioner deemed an examination of Farmers necessary due to a significant increase in the

number of complaints, which TDI had received against Farmers, regarding enormous rate increases for homeowners insurance policies.

18. From January 1, 2001 through December 31, 2001, TDI received 86 written complaints concerning Farmers' homeowners rates. From January 1, 2002 through July 31, 2002, TDI received 248 written complaints concerning Farmers Insurance Exchange's homeowners rates.

Complaints Regarding Farmers' Homeowners Rates in 2002

19. Complaints received by TDI in 2002 indicate that many Farmers' Texas HO-A policyholders are still receiving rate increases as high as 200 percent. Examples of the kinds of concerns expressed by consumers are as follows:

> "My home owners (*sic*) insurance premium has just been increased by over 300 percent by Farmers. My auto insurance under Farmers also has increased by about 40 percent. I cannot afford to pay this increase. I started to call other companies and was told that they are not writing new policies. Who cares?"

> "My homeowner's insurance premium went up from $850 to $1,200.00 an almost 50% (*sic*)."

> "In the year of 2001, my premium was $932.00. My premium for the year of 2002 is $2,194.00."

> "We had a policy with Farmers Insurance for at lease (*sic*) 13 years and all of a sudden we are told that our original policy has been cancelled and another policy issued with over a 100% increase of premium. We were told that this is due to mold claims. I can understand rewriting the policy to reflect no mold coverage & (*sic*) even a small increase, (*sic*) They rewrote the policy and increased my premium from $86.00 to $197 monthly. We were told this only affected the State of Texas."

> "…Through my own experience as a homeowner in Harris County my insurance company (FARMERS) has recently increased my home insurance premium by 113%. Moreover, this increase represents less coverage. It seems to me that this is an extremely unfair burden for the consumer…."

> "…It has come to my attention that my homeowners premium has doubled from last year…. I have an invoice from Fire Insurance Exchange …indicating that the

> total premium amount is $3,202.00 with an optional payment of $1,608.00 *(sic)* due now and the balance of $1,601.00 due 60 days after the renewal date of July 15, 2002. The bank has indicated that that amount is not available in my escrow to make such a payment. The previous years (*sic*) payments have been $1,500 for the year."
>
> "Although I didn't have claims due to the Allison flood, my rates went up 248% in one year. 2001 - $1,750.00 approx. –2002 – 4340.00."
>
> "My premium rates jumped from 490.00 per year to 990.00 per year. The rate increase is just not reasonable. It seems that the policyholder has no options."
>
> "I have worked hard all my life for my little frame home, did without food, medications, and comforts to buy my home for retirement, and now without any coverage my life long investment is in desperate danger from either the State of Texas or natural disaster.
>
> I have had homeowners with Farmers Ins. For *(sic)* over thirty years and now, they are not renewing my coverage as of Feb. 20, 2002. They will issue some other coverage (if you can call it that), for a few bucks less than this whiz-bang policy that has a lot less coverage, but it is double what I currently pay."

See Exhibit 1 attached hereto and incorporated herein for sample complaints. All identifying information has been redacted to protect consumers' privacy.

Farmers Market Share

20. Farmers, together with affiliate Texas Farmers Insurance Company, was the second largest homeowners insurer in Texas at the end of 2000, with a market share of 18.5 percent. Farmers Insurance Exchange had a market share of 11.41 percent, Fire Insurance Exchange had a market share of 5.61 percent and Texas Farmers Insurance Company had a market share of 1.48 percent at the end of 2000.

Farmers' Homeowners Insurance Policies in Force in Texas

21. Farmers Insurance Exchange's annual statement for the year ending December 31, 2000 accounted for direct premiums written of $379,868,499 for Texas policyholders. Included in the

total were 365,147 homeowners policies with direct premiums written of $334,798,871. Fire Insurance Exchange's annual statement for the year ending December 31, 2000, accounted for direct premiums written of $221,380,606 for Texas policyholders. Included in that total were 179,602 homeowners policies with direct premiums written of $182,475,306.

22. Farmers Insurance Exchange and Fire Insurance Exchange noted 487,729 homeowners policies in force on December 31, 2001, with direct premiums written of $596,636,362, an increase of $79,362,185 from 2000. The totals included 54,111 HO-A policies in force with direct premiums written of $47,066,965 and 106,198 HO-B policies in force with direct premiums written of $131,554,718 for Fire Insurance Exchange. The totals also included 327,420 HO-B policies in force with direct premiums written of $418,014,679 for Farmers Insurance Exchange.

Farmers Ceases Writing HO-B Policies in Texas

23. In 2001, Farmers decided to change their offerings in Texas and cease writing HO-B policies "as a result of the huge number of unexpected water and mold losses Farmers and the industry is experiencing in Texas." Farmers ceased writing HO-B policies for new applicants beginning August 15, 2001. Farmers also ceased writing new HO-B policies for existing policyholders effective November 14, 2001. Farmers ceased the renewal of direct-billed HO-B policies with effective dates of December 30, 2001. Farmers also ceased the renewal of mortgagee billed HO-B policies beginning with effective dates of January 1, 2002. All Farmers' HO-B policies will be non-renewed and either re-written as a HO-A policy, HO-A policy with the TX040 amendatory endorsement, or lapsed by January 1, 2003.

24. In November 2001, Farmers asked for the Commissioner's approval to offer an enhanced HO-A policy with TX040 amendatory endorsement attached. Pursuant to TEX. INS. CODE ANN. art. 5.35, the Commissioner approved the endorsement. These policies provide less coverage than the HO-B policies, but considerably more than the basic HO-A policies. The endorsement does not cover mold. In July 2002, Farmers filed a revision, which was approved, to the TX040 to provide coverage consistent with Commissioner's Order No. 01-1105.

Staff's Examination of Farmers and Findings

25. Pursuant to TEX. INS. CODE ANN. arts. 1.15 and 21.21 § 5, and in accordance with the Commissioner's instructions, Staff initiated the exam process. During the course of the examination process Staff obtained historical experience data from Farmers that would allow review of the fairness of Farmers' charges. This data included premiums and losses as well as other information normally used by actuaries to determine the necessary level of premiums. Because Staff was reviewing HO-A rates, the only policy Farmers is currently writing for new and renewal business, Farmers adjusted the loss data supplied to Staff to remove water damage claims and losses involving mold.

26. Staff's review of the data received from Farmers, using standard actuarial procedures, revealed the following:

A. The assumptions used by Fire Insurance Exchange lead to unfair rates which unfairly caused its Texas HO-A policyholders to overpay by more than 50 percent in violation of TEX. INS. CODE ANN. art. 21.21 § 3 and 28 TEX. ADMIN. CODE §§ 21.1-21.5. This includes condominium owners and tenants.

B. The assumptions used by Farmers Insurance Exchange lead to unfair rates which unfairly caused its Texas HO-A policyholders to overpay by more than 17 percent in violation of TEX. INS. CODE ANN. art. 21.21 § 3 and 28 TEX. ADMIN. CODE §§ 21.1-21.5.

C. Farmers sets their unfair Texas HO-A policy rates by using the following: coverage differences between HO-A and the data used to calculate rate needs, unfunded CAT load, assignment of Farmers Property Risk Assessment (FPRA) score and age of home discounts, excessive target rates of return, excessive trend factors, and excessive length of trending periods.

Farmers' Unfair Methods of Competition or Unfair or Deceptive Acts or Practices

27. The following methods contribute to the unfairness of Farmers' Texas HO-A policy rates.

Coverage Differences between HO-A and The Data Used to Calculate Rate Needs

28. Farmers developed rate needs for HO-A largely based on experience under HO-B with water damage and mold-related claims removed. While coverage for water damage and mold-related claims represent the most significant difference between the HO-A and the HO-B, especially with the rapid escalation of mold claims in the past two years, other coverage differences also exist. Probably the most significant other difference is that the HO-A contract is an actual cash value contract (that is, claims are paid on the basis of replacement cost less depreciation) whereas the HO-B is a replacement cost contract.

29. While Farmers offers replacement cost coverage under the HO-A policy through an endorsement, this is provided only at an additional cost to policyholders. It is therefore not appropriate to include the cost of this coverage enhancement in the basic HO-A rate. Using data

that largely reflects replacement cost coverage, which is not covered by the HO-A, further unfairly causes Farmers' rate needs to be overstated because Farmers would be collecting for replacement cost, both in the HO-A premium and in the endorsement premium. This is "double-counting". This unfair overstatement of rate needs by Farmers is unfairly causing their Texas HO-A policyholders to overpay.

Unfunded CAT Load

30. Homeowners policies provide coverage for certain natural disasters or catastrophes such as hurricanes, tornadoes, and severe hailstorms. Traditionally, this potential catastrophe loss has been reflected by Farmers in its Texas rates by including two "loads" in the rates: one to reflect potential hurricane-related losses, another to reflect other natural disasters. These loads are known as "catastrophe loads" or "CAT loads". On approximately September 16, 2001, Farmers introduced a third load, a so-called "unfunded CAT load." This was intended to provide for perceived shortfalls in the traditional catastrophe loads across the country. Farmers' records do not indicate that the traditional catastrophe loads in Texas are inadequate. Moreover, it is inappropriate for Farmers to include this new load in Texas rates in order to pay for shortfalls elsewhere. By including this unfunded CAT load in their rates Farmers is unfairly causing their Texas HO-A policyholders to overpay for their coverage.

Assigning Farmers Property Risk Assessment (FPRA) Discounts

31. Farmers offers certain discounts to qualifying applicants and policyholders. On approximately November 16, 2000, Farmers introduced a discount based on a credit scoring system, Farmers Property Risk Assessment (FPRA). The FPRA based discount is the biggest individual discount offered by Farmers. FPRA purports to demonstrate a correlation between a

policyholder's credit history and the likelihood of the policyholder filing a claim. Farmers converts the policyholder's credit score to an alpha code from A to Z and assigns each alpha a discount factor. Farmers gives the policyholder a discount based on the policyholder's credit score. In theory, the better the policyholder's credit score, the higher the discount.

32. On approximately September 16, 2001, Farmers increased credit score discounts dramatically. The discount adopted for policyholders with the best so-called FPRA scores closely approximated the discount indicated by their loss experience: based on Farmers' own data the indicated discount for FPRA categories A, B, C, and D was 47.8 percent and the discount that was granted was 47 percent. Policyholders with less favorable credit scores did not fare as well, however. For example, policyholders in FPRA categories L, O, and P had a discount of 31.6 percent indicated by their loss experience, but were granted only a 15 percent discount. In fact, the discounts granted to all but the very best categories (A, B, C, and D) and the very worst (U, V W, X, Y, and Z, with no discount) were substantially below the indicated discounts. *See* Exhibit 2 attached hereto and incorporated herein. This failure to treat policyholders consistently in assigning discounts is an unfair practice. Farmers is unfairly overcharging those Texas HO-A policyholders that are not receiving the FPRA indicated discount.

Age of Home Discount

33. On approximately December 16, 2001, the discounts Farmers offers policyholders with homes that are zero to six years old were increased dramatically. The discounts were further expanded on approximately January 16, 2002, in order to provide discounts for policyholders with homes that were seven to nine years old. The discount for policyholders with the newest homes (zero and one year old) closely approximated the indicated discount: based on Farmers'

own data the combined indicated discount was approximately 38 percent (although the indication for a zero age home was 26.5 percent and that for a one year old home was 43.7 percent) and the discount that was adopted was 40 percent. Policyholders with older homes generally did not fare as well, however. For example, policyholders with seven-year-old homes had a discount indicated by the loss experience of 28.9 percent but were assigned only a 15 percent discount. In fact, with one exception, the discounts granted to all but the very newest homes (zero and one year old) and a group of older homes (10-30 years old, with no discount) were substantially below the indicated discounts. In fact, homes more than 30 years old had indicated discounts that were not granted at all. *See* Exhibit 2 attached hereto and incorporated herein. This failure to treat policyholders consistently in assigning discounts is an unfair practice. Therefore, Farmers is unfairly overcharging their Texas HO-A policyholders that are not receiving the indicated age of home discount.

Effective Target Rate of Return

34. Farmers Group, Inc. is the parent company of Farmers Underwriters Association and Fire Underwriters Association. Farmers Underwriters Association is the Attorney-In-Fact of Farmers Insurance Exchange. Fire Underwriters Association is the Attorney-In-Fact of Fire Insurance Exchange. Farmers Group, Inc. administers Farmers Insurance Exchange and Fire Insurance Exchange and charges a management fee for that administration. The management fee is calculated as a percentage of homeowners insurance premiums (including Texas HO-A premiums) collected by Farmers Insurance Exchange and Fire Insurance Exchange.

35. Farmers Insurance Exchange and Fire Insurance Exchange's rate calculations directly used an after-tax target rate of return on surplus of 15 percent to determine the underwriting

profit provision in the rates. In addition, the expenses underlying Farmers Insurance Exchange and Fire Insurance Exchange's rates reflect the management fee paid to Farmers Group, Inc.

36. In SEC filings, Farmers Group, Inc. states that in 2001, over 40 percent of its management fee income was operating income, which translates into approximately 5.5 percent of Farmers Insurance Exchange and Fire Insurance Exchange's premiums. While there is no ownership relationship between Farmers Group, Inc. and Farmers Insurance Exchange and Fire Insurance Exchange, this transfer of profits to Farmers Group, Inc. is akin to an upstream dividend within a holding company system. Such dividends are normally made from the operating profits of the subsidiary insurers; that is, from the operating returns earned by those insurers.

37. In combination, the 15 percent target rate of return and the profit implicit in the management fee paid to Farmers Group, Inc. produce an effective after-tax target rate of return (i.e. profit) implicit in Farmers Insurance Exchange and Fire Insurance Exchange's rates of more than 25 percent. This is a high rate of after-tax return. To put this in context, in recent benchmark rate case decisions, the Commissioner has adopted after-tax rates of return of approximately 11.5 percent to 12.5 percent for rate regulated companies based on detailed economic studies and testimony. While TDI expects Farmers to make a reasonable profit, use of a 25 percent after-tax rate of return, without justification, produces unfair rates, which causes Farmers' Texas HO-A policyholders to overpay.

Excessive Trend Factors

38. Actuaries use trend factors to reflect likely changes in loss costs (both in average costs per claim and in the relative numbers of claims, also referred to as "claims frequencies") and in

average premiums between the time of the historical experience used in the rate calculations and the time the new rates will be in effect. The increase in cost relative to premium forecast used by Farmers is extremely high by any traditional actuarial measure, especially bearing in mind that the underlying data did not include any water damage or mold-related claims, two areas where losses had been increasing substantially. Reducing the anticipated increase in cost to more typical and reasonable levels substantially reduces the indicated rate needs of Farmers. Therefore, Farmers' use of excessive trend factors unfairly causes Farmers' Texas HO-A policyholders to overpay.

Length of Trending Periods

39. Actuaries typically assume that rates will remain in effect for a year. This means that they assume that the average policy that will be subject to the new rates will be effective six months after the new rates go into effect, and calculate likely increases in cost accordingly. Farmers, however, increased their rates considerably more frequently than once a year in 2000 and 2001. In fact, they increased their rates on an overall basis (excluding the introduction of new discounts and the like) four (4) times during that period, or roughly an average of every six months. *See* Exhibit 3 attached hereto and incorporated herein. Shortening the trending period to reflect the more frequent rate revisions eliminates three months of trend.

40. Given that the trends are upward, and that trending for the additional three months produces higher rates, this causes Farmers to unfairly overstate their rate needs resulting in overpayments by Farmers' Texas HO-A policyholders.

Consumer Harm

41. Policy count data provided by Farmers to the Texas Insurance Checking Office shows a substantial decrease in Farmers' Texas written policy counts beginning September 2001 and continuing through February 2002. This means that consumers were leaving Farmers, and obtaining their coverage elsewhere or going "bare", i.e., with no coverage. September 16, 2001 marks the first of two massive changes in rates for Farmers in 2001. The Farmers Insurance Exchange rate increase for the average policyholder was approximately 29 percent, but was approximately 68 percent for policyholders not eligible for discounts such as FPRA and Age of Home. The corresponding changes for Fire Insurance Exchange were approximately 24 percent and 61 percent. Rates were further increased on December 16, 2001. The additional increase for the average policyholder in the two exchanges was approximately 20 percent, while it was about 26 percent for those not eligible for the discounts. In total, the average policyholder renewing coverage after December 16 would see about a 50 percent increase, while those with poorer credit scores or older homes would see rises of more than 100 percent, and in certain territories, much more.

42. Clearly, the people most adversely affected by these increases would be those with lower credit scores and older homes. Those least able to afford the increases would be those with lower or fixed incomes. Some of these would leave Farmers, finding coverage somewhere else at more affordable rates. Others would simply decide to "go bare", dropping their coverage altogether if they were fortunate enough not to have a mortgage. Home insurance would simply be a luxury compared to other demands on their resources such as medical costs or even minimum liability coverage for their auto.

43. Is this scenario reasonable? Yes. All we have are some consumer complaints saying that this is what people had to do. Such individuals are the ones who are irreparably harmed.

44. As indicated by the complaints attached hereto and incorporated herein as Exhibits 1, 4 and 5, Farmers often is not telling Texas HO-A policyholders the reason for their increased premiums. In a representative case, a Fire Insurance Exchange Texas HO-A policyholder complained to TDI of an increase in her annual premium from $1,500 to $3,202. See Exhibit 4 attached hereto and incorporated herein. Assuming the policyholder's home was worth more than $95,000 given the size of the premium, the policyholder received a 207 percent increase prior to the application of any discounts in Fire Insurance Exchange and any savings between an HO-B and the HO-A simply due to the move from Texas Farmers Insurance Company to Fire Insurance Exchange.

45. TDI sent the complaint to Fire Insurance Company, and in a written response to the policyholder, Fire Insurance Exchange stated that the policyholder's Texas Farmers Insurance Company HO-B policy was non-renewed and rewritten under a Fire Insurance Exchange HO-A policy. With regard to the reason for the premium increase experienced by the policyholder Fire Insurance Exchange stated:

> The number and size of homeowners weather losses and the rising costs of repairing and replacing property damage have resulted in higher premiums for homeowners insurance.

See Exhibit 4 attached hereto and incorporated herein.

46. In a representative case, a Farmers Insurance Exchange Texas HO-A policyholder complained to TDI of a one thousand dollar ($1,000) increase in her annual premium. In a written response to the policyholder's complaint, Farmers Insurance Exchange stated that the

policyholder's Texas Farmers Insurance Company HO-B policy was non-renewed and rewritten under a Fire Insurance Exchange HO-A policy. TDI sent the complaint to Farmers Insurance Exchange, and in a written response to the policyholder, Farmers Insurance Exchange stated:

> The number and size of homeowners weather losses and the rising costs of repairing and replacing property damage have resulted in higher premiums for homeowners insurance. These weather losses, the rising costs for repairing and replacing property damage and the significant increase of water and mold claims have resulted in higher premiums for homeowners insurance.

See Exhibit 5 attached hereto and incorporated herein.

47. In two other instances Farmers simply did not tell the truth. Regarding the effect of credit scoring, the company stated.

> "These along with several other factors are entered into the risk assessment model to produce an insurance score. This score issued to determine the discount on your homeowners policy. As these discounts are filed with the Texas Department of Insurance, we must adhere to the rate filing. This means that we must only give the discount that corresponds with your insurance score."

This is simply not true. Farmers Insurance Exchange and Fire Insurance Exchange are reciprocal exchanges. They are not subject to the flexible "rating system". They need not, an in fact, do not file their homeowners insurance rates with TDI. *See* Exhibit 6 attached hereto and incorporated herein.

48. While it may be true that the number and size of homeowners weather losses and the rising costs of repairing and replacing property damage contribute to higher premiums for homeowners insurance, a bigger factor in many cases is the switch from a rate regulated company to a non-rate regulated company. All else equal, the basic rates (not including endorsements) for Fire Insurance Exchange and Farmers Insurance Exchange's HO-A policies are frequently more than three (3) times the HO-B rates of Texas Farmers Insurance Company.

Cease and Desist Order

49. The Commissioner ex parte may issue an emergency cease and desist order if the Commissioner believes that an authorized insurer is committing an unfair act and it appears to the Commissioner that the conduct of the authorized insurer is causing or can be reasonably expected to cause public injury that:

(i) is likely to occur at any moment;
(ii) is incapable of being repaired or rectified; and
(iii) has or is likely to have influence or effect.

TEX. INS. CODE ANN. § 83.051(a)(1)(A)(i)(2)(C).

50. TDI believes that by charging unfair HO-A policy rates in Texas, Farmers is causing injury to the public which is incapable of being repaired or rectified and has influence or effect as contemplated by TEX. INS. CODE ANN. § 83.051(a)(A)(i)(2)(C). TDI further believes that, unless immediately ordered to cease and desist, Farmers will continue causing such injury to the public in violation of TEX. INS. CODE ANN. art. 21.21 § 3 and 28 TEX. ADMIN. CODE §§ 21.1-21.5.

51. Farmers' violations with respect to unfair rates for Texas HO-A policies are of such magnitude that an order to simply cease and desist using unfair rates in Texas could, as a practical matter, and in all likelihood would, substantially affect Texas HO-A homeowners insurance in Texas. Were Farmers to immediately cease and desist using unfair HO-A policy rates in Texas, Farmers would have no rates in effect for HO-A policies in Texas. Consequently, Farmers would not be able to issue HO-A policies in Texas. This would affect both new business as well as renewal business. As a result, consumers might be left without insurance. From an administrative standpoint, Farmers would have no time to change their rating system or

get a revised rating system to their agents so that Texas HO-A policies could be correctly rated. Furthermore, Farmers has already sent out renewal notices to their Texas HO-A policyholders for future renewals based on the current rates and collected premium.

New and Renewal Rates

52. This Application does not seek to directly or indirectly cause harm to consumers. Due to the gravity of the consumer harm caused by Farmers' unfair Texas HO-A rates, however, Staff believes that Farmers' unfair Texas HO-A rates warrant an emergency cease and desist order. Therefore, in order to minimize the potential for further consumer harm, and to give Farmers time to take the necessary steps to fix their Texas HO-A rates, Staff recommends that the Commissioner should enter an order whereby Farmers, their agents, employees, and/or other representatives, are ordered to cease and desist from using the methods set forth in the following sub-paragraphs (a) through (g), in whole or in part, to determine rates for new and renewal Texas HO-A policies that become effective later than ninety (90) days from the date of the order:

(a) Using data that largely reflects replacement coverage in calculating rates charged for HO-A coverage;
(b) Using an unfunded catastrophe load in calculating rates for HO-A coverage;
(c) Failing to provide indicated discounts under Farmers Property Risk Assessment (FPRA) to policyholders with HO-A coverage who fall under alpha codes E, F, G, H, I, J, K, L, N, O, P, Q, R, S and T, in calculating rates charged for HO-A coverage;
(d) Failing to provide indicated age of home discounts to policyholders with homes aged as follows: 2, 4, 5, 6, 7, 8, 9 years, in calculating rates charged for HO-A coverage;
(e) Using excessive trend factors in calculating rates charged for HO-A coverage;
(f) Using too long of a trending period because rate revisions for HO-A coverage are more frequent than annual; and
(g) Using an excessive target rate of return in calculating rates charged for HO-A coverage.

Existing Texas HO-A Rates

53. Staff recommends that the Commissioner should enter a cease and desist order against Farmers, their agents, employees, and/or other representatives prohibiting Farmers, their agents, employees, and/or other representatives, from implementing any base rate or rating factor using the methods set forth in the following sub-paragraphs (a) through (g), in whole or in part, which increase Texas HO-A rates in effect on the date of the order:

(a) Using data that largely reflects replacement coverage in calculating rates charged for HO-A coverage;
(b) Using an unfunded catastrophe load in calculating rates for HO-A coverage;
(c) Failing to provide indicated discounts under Farmers Property Risk Assessment (FPRA) to policyholders with HO-A coverage who fall under alpha codes E, F, G, H, I, J, K, L, N, O, P, Q, R, S and T, in calculating rates charged for HO-A coverage;
(e) Failing to provide indicated age of home discounts to policyholders with homes aged as follows: 2, 4, 5, 6, 7, 8, 9 years, in calculating rates charged for HO-A coverage;
(e) Using excessive trend factors in calculating rates charged for HO-A coverage;
(f) Using too long of a trending period because rate revisions for HO-A coverage are more frequent than annual; and
(g) Using an excessive target rate of return in calculating rates charged for HO-A coverage.

VI. RELIEF REQUESTED

WHEREFORE, PREMISES CONSIDERED the Enforcement Section, Legal and Compliance Division requests the Commissioner of Insurance to:

1. Make a decision pursuant to TEX. INS. CODE ANN. art. 21.21 §§ 3 and 5 that Farmers Insurance Exchange and Fire Insurance Exchange are engaged in unfair methods of competition or unfair or deceptive acts or practices in the business of

insurance in Texas by unfairly overcharging policyholders for HO-A coverage through these methods:

(a) Using data that largely reflects replacement coverage in calculating rates charged for HO-A coverage;
(b) Using an unfunded catastrophe load in calculating rates for HO-A coverage;
(c) Failing to provide indicated discounts under Farmers Property Risk Assessment (FPRA) to policyholders with HO-A coverage who fall under alpha codes E, F, G, H, I, J, K, L, N, O, P, Q, R, S and T, in calculating rates charged for HO-A coverage;
(d) Failing to provide indicated age of home discounts to policyholders with homes aged as follows: 2, 4, 5, 6, 7, 8, 9 years, in calculating rates charged for HO-A coverage.
(e) Using excessive trend factors in calculating rates charged for HO-A coverage;
(f) Using too long of a trending period because rate revisions for HO-A coverage are more frequent than annual; and
(g) Using an excessive target rate of return in calculating rates charged for HO-A coverage.

2. Make a decision pursuant to TEX. INS. CODE ANN. art. 21.21 §§ 3, 4, and 5 that Farmers Insurance Exchange and Fire Insurance Exchange's unfair acts, practices or conduct or unfair methods of competition in the business of insurance are harming Farmers Insurance Exchange and Fire Insurance Exchange's Texas HO-A policyholders.

3. Make a decision pursuant to TEX. INS. CODE ANN. art. 21.21 §§ 3 and 5 that the harm caused by Farmers Insurance Exchange and Fire Insurance Exchange's unfair overcharging of Texas policyholders for HO-A coverage in violation of TEX. INS. CODE ANN. art. 21.21 §§ 3 and 5, and 28 TEX. ADMIN. CODE §§ 21.1-21.5 must be stopped, but that due to the potential of even more consumer harm and administrative difficulty to Farmers Insurance Exchange and Fire Insurance Exchange

which may result from an order that Respondents immediately cease and desist their unfair HO-A rates in Texas, enter an order that Farmers Insurance Exchange and Fire Insurance Exchange shall do as follows:

A. New and Renewal Texas HO-A Rates

Cease and desist from using the methods set forth in the following sub-paragraphs (a) through (g), in whole or in part, to determine rates for new and renewal Texas HO-A policies that become effective later than ninety (90) days from the date of the order:

(a) Using data that largely reflects replacement coverage in calculating rates charged for HO-A coverage;

(b) Using an unfunded catastrophe load in calculating rates for HO-A coverage;

(c) Failing to provide indicated discounts under Farmers Property Risk Assessment (FPRA) to policyholders with HO-A coverage who fall under alpha codes E, F, G, H, I, J, K, L, N, O, P, Q, R, S and T, in calculating rates charged for HO-A coverage;

(d) Failing to provide indicated age of home discounts to policyholders with homes aged as follows: 2, 4, 5, 6, 7, 8, 9 years, in calculating rates charged for HO-A coverage.

(e) Using excessive trend factors in calculating rates charged for HO-A coverage;

(f) Using too long of a trending period because rate revisions for HO-A coverage are more frequent than annual; and

(g) Using an excessive target rate of return in calculating rates charged for HO-A coverage.

B. Existing Texas HO-A Rates

Cease and desist from implementing any base rate or rating factor changes using the methods set forth in the following sub-paragraphs (a) through (g), in whole or in part, which increase Texas HO-A rates in effect on the date of the cease and desist order:

(a) Using data that largely reflects replacement coverage in calculating rates charged for HO-A coverage;

(b) Using an unfunded catastrophe load in calculating rates for HO-A coverage;

(c) Failing to provide indicated discounts under Farmers Property Risk Assessment (FPRA) to policyholders with HO-A coverage who fall under alpha codes E, F, G, H, I, J, K, L, N, O, P, Q, R, S and T, in calculating rates charged for HO-A coverage;

(d) Failing to provide indicated age of home discounts to policyholders with homes aged as follows: 2, 4, 5, 6, 7, 8, 9 years, in calculating rates charged for HO-A coverage.

(e) Using excessive trend factors in calculating rates charged for HO-A coverage;

(f) Using too long of a trending period because rate revisions for HO-A coverage are more frequent than annual; and

(g) Using excessive target rate of return in calculating rates charged for HO-A coverage.

4. Immediately without notice or hearing, issue a cease and desist order under TEX. INS. CODE ANN. § 83.051 and 28 TEX. ADMIN. CODE § 1.901 ordering Farmers Insurance Exchange and Fire Insurance Exchange to cease and desist their unfair Texas HO-A rates, which are in violation of TEX. INS. CODE ANN. art. 21.21 § 3 and 28 TEX. ADMIN. CODE §§ 21.1-21.5, as follows:

A. New and Renewal Texas HO-A Rates

Cease and desist from using the methods set forth in the following sub-paragraphs (a) through (g), in whole or in part, to determine rates for new and renewal Texas HO-A policies that become effective later than ninety (90) days from the date of the order:

(a) Using data that largely reflects replacement coverage in calculating rates charged for HO-A coverage;

(b) Using an unfunded catastrophe load in calculating rates for HO-A coverage;

(c) Failing to provide indicated discounts under Farmers Property Risk Assessment (FPRA) to policyholders with HO-A coverage who fall under alpha codes E, F, G, H, I, J, K, L, N, O, P, Q, R, S and T, in calculating rates charged for HO-A coverage;

(e) Failing to provide indicated age of home discounts to policyholders with homes aged as follows: 2, 4, 5, 6, 7, 8, 9 years, in calculating rates charged for HO-A coverage.

(e) Using excessive trend factors in calculating rates charged for HO-A coverage;

(f) Using too long of a trending period because rate revisions for HO-A coverage are more frequent than annual; and

(g) Using an excessive target rate of return in calculating rates charged for HO-A coverage.

B. Existing Texas HO-A Rates

Cease and desist from implementing any base rate or rating factor changes using the methods set forth in the following sub-paragraphs (a) through (g), in whole or in part, which increase Texas HO-A rates in effect on the date of the cease and desist order:

(a) Using data that largely reflects replacement coverage in calculating rates charged for HO-A coverage;

(b) Using an unfunded catastrophe load in calculating rates for HO-A coverage;

(c) Failing to provide indicated discounts under Farmers Property Risk Assessment (FPRA) to policyholders with HO-A coverage who fall under alpha codes E, F, G, H, I, J, K, L, N, O, P, Q, R, S and T, in calculating rates charged for HO-A coverage;

(d) Failing to provide indicated age of home discounts to policyholders with homes aged as follows: 2, 4, 5, 6, 7, 8, 9 years, in calculating rates charged for HO-A coverage.

(e) Using excessive trend factors in calculating rates charged for HO-A coverage;

(f) Using too long of a trending period because rate revisions for HO-A coverage are more frequent than annual; and

(g) Using excessive target rate of return in calculating rates charged for HO-A coverage.

TDI, through the Enforcement Section, Legal and Compliance Division, requests any and such further relief, both at law and in equity, to which it may be entitled.

Respectfully submitted this 13th day of August 2002.

Karen A.L. Barratt
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Legal and Compliance Division, MC, 110-1A
Texas Department of Insurance
333 Guadalupe
Austin, Texas 78701
State Bar No. 01805250
Telephone: (512) 475-1832
Fax: (512) 475-1772

THE STATE OF TEXAS §
§
COUNTY OF TRAVIS §

BEFORE ME, a notary public in and for the State of Texas, on this day personally appeared C. H. Mah, known to me to be the person whose name is subscribed to the foregoing instrument, and acknowledged to me that he executed the same, who being by me duly sworn, deposed as follows:

"My name is C. H. Mah. I am of sound mind, capable of making this statement, and personally acquainted with the facts herein stated.

I am the Senior Associate Commissioner of the Property & Casualty Division. I verify that I have carefully read the allegations contained in the foregoing Application for Emergency Cease and Desist Order, and that to the best of my knowledge each and every one of said allegations is true and correct."

Signature of Affiant

C. H. MAH

Printed Name of Affiant

Given under my hand and seal of office this 13 day of August 2002.

GINGER YOCOM
Notary Public, State of Texas
My Commission Expires
DECEMBER 21, 2004

Ginger Yocom

Signature of Notary Public

Ginger Yocom

Printed Name of Notary Public

NOTARY PUBLIC IN AND FOR THE STATE OF TEXAS

My Commission Expires: 12.21.04