

July 5, 2012

To: The Honorable Senate Business and Commerce Committee

From: The Office of Public Insurance Counsel

**RE: Senate Interim Charges/Requested Testimony**

Chairman Carona and Committee Members:

As requested by the committee, we are filing the following in supplementation to the Public Counsel's testimony. The following comments are not exhaustive of all possibilities, rather, we have narrowed our comments to those measures we deem the most appropriate and feasible. The committee requested input on the following topics:

1. Lowering homeowners rates;
2. Improving transparency, consumer education, and awareness of state insurance resources;
3. Recommendations to ensure consumers are treated fairly; and
4. Opine concerning use by insurers of customer inquiries in rating and underwriting decisions.

**OPIC'S CONCERNS/OBSERVATIONS REGARDING  
TEXAS HOMEOWNERS INSURANCE MARKET**

Before making specific suggestions, we believe that it will be helpful to include some background by providing information about our observations of the marketplace.

**The trend toward lower coverage**

There is an undeniable trend toward lower (less) coverage in Texas homeowners policies. Texas has, by far, the highest percentage of named-peril residential policies in the country. From the most recent NAIC data, 43.6% of Texas policies were named-peril as opposed to all-risk policies. The next highest state is Oklahoma with 13.2% named-peril policies. In 2001, the Texas percentage of named-peril policies was 13%.

Additionally, deductibles have increased significantly. The chart attached as Exhibit "1" represents a comparison by year of the levels of the deductibles for wind coverage in Tier 2

(counties geographically behind the Tier 1 coastal counties). In the five years represented, the percentage of 2% or greater deductibles has more than doubled.

### **Massive ceding of risk**

As of March 2012, Tier 1 residential wind exposure ceded to TWIA totaled 59.3 billion dollars. In spite of this, private market reinsurance purchases increase. These charges are effectively passed through to the consumer with little scrutiny. Some of the reinsurance purchases represent loads of 10 to 15% of prospective statewide earned premium. Additionally, some have low expected recovery rates, are placed with affiliated companies, and reinsure non-hurricane catastrophe risk. Please note that this criticism is not directed toward some private market and all TWIA reinsurance purchases at current levels. OPIC believes these purchases are appropriate and warranted given the catastrophe risk to which they remain exposed.

### **Excessive rates**

Excessive rates currently observed are typically the result of inflated catastrophe loads and unreasonable target rates of return. The inflated catastrophe loads are a function of the use of questionable models, non-hurricane catastrophe loads that ignore increasing deductibles, and extra profit loads built in for retained risk. Concerning target rates of return, recent filings range from 12 to 18%. This is far in excess of market rates. Additionally, the target rates of return generally do not account for the ceding of catastrophe risk. If they did, the target rate would be lower. A chart of the profitability for homeowners insurers since 2004 is attached hereto as Exhibit "2". Please note that the loss ratios listed were not reduced for reinsurance recoveries.

### **The "trust gap" between industry and regulators**

The "trust gap" refers to the often complex relationship between the industry and the agencies that regulate (or weigh in) on their business practices. The industry complains of the lack of regulatory consistency and what appears to be a "file and haggle" instead of a file and use system. As the state consumer advocate, OPIC is concerned with inadequate rate filings and inflated indications that bear little relation to the insurer's real rate need.

## **SPECIFIC RECOMMENDATIONS**

With the background and observations noted above, we offer the following:

### **LOWERING HOMEOWNERS RATES/INCREASING TRANSPARENCY/EDUCATION**

The ultimate price paid by the consumer for insurance, the premium, is a function of both the insurance rate and the value of the property insured as determined by the insurance carrier. Therefore, while the following are directed to lowering rates, we must be mindful that rate is only one part of the equation.

#### **1. Rate Filing Requirements Must Be Enhanced**

This recommendation is intended to address the trust gap and excessive rate issues noted above. As stated earlier, many rate filings are woefully inadequate making it impossible to determine if the requested rate is appropriate. The problem goes back to the adoption of 28 TEX. ADMIN. CODE §5.9332, often called the Filings Made Easy rule. This rule has been interpreted by some in the industry to mean that companies have full discretion to file whatever information they like up front. The Texas Department of Insurance (“TDI”) then has the burden to request supplemental information if the filing doesn’t satisfy the rule requirements.

This process has resulted in inconvenience and inefficiency for both regulators and the industry. Some in the industry complain that the requests for information create a “file and haggle” system where carriers are never sure if the filing has satisfied the department. For TDI and OPIC, the system means that many filings cannot be fully determined to comply with rating standards until long after the rates become effective. In some, but not all cases, filings are implemented for use immediately upon submission.

While some of the incomplete filings are the result of a lack of clarity on the requirements, others appear intended to see how little information the company can get away with filing. Filings with pieces of critical information omitted are so common as to be nearly the rule as opposed to the exception. We believe that increased accountability would likely limit some of the more abusive omissions of key information. To help alleviate this issue, we have supported and assisted TDI’s efforts to develop rate filing templates. We believe the use of these

templates would be a significant improvement to the rate filing process and should be required by rule or statute.

## 2. If a Rate Component Cannot Be Evaluated, It Should Not Be Included

As long as there are rate components that cannot be fully evaluated, regulators cannot effectively evaluate the rate filing. This specifically refers to the use of models and reinsurance arrangements. With models, we are basically required to accept at face value the model's results while knowing little of the model itself. Modeling results can vary widely between models and year to year for the same model. Also, the modeling industry's primary clients are insurance companies making them potentially less than completely neutral. Finally, the reliability of the models is highly questionable when a single event, such as Hurricane Ike, can result in such drastic revisions. This happened recently with the RMS model which increased parts of Harris County's hurricane risk by more than 30%. The industry counters that modelers claim their work is proprietary and thus not subject to disclosure, and/or, that Texas law as written creates a risk of disclosure that is unacceptable to the modelers.

In coastal and near-coastal areas of Texas, property insurance premiums associated with hurricane losses can be significant. Depending on the insurance company, and a property's location, the percentage of premium comprised of expected hurricane losses and reinsurance for hurricane losses can be 20-50%. Evaluating the reasonability of both modeled hurricane losses and reinsurance issues can be very difficult. The concern is that insurance rate-making is becoming increasingly subject to proprietary black box products that cannot be reviewed. This creates great difficulty in trying to ascertain whether rates are not excessive, confiscatory or discriminatory.

In the case of hurricane models, very little information is typically filed. Often, only the output result of the model is provided. Frequently, we are unable to determine important issues like: 1) whether the model includes a provision for storm surge (flood is not covered by most standard policies), 2) which version of the model is used, 3) whether the model artificially inflates hurricane frequency above the long-term average, or 4) whether the model includes a provision for demand surge, the temporary inflation in materials and labor that often

accompanies a catastrophe. We also typically don't have access to the qualifications and caveats issued by the modelers that accompany the output.

These problems are relatively easy to fix. A more difficult problem is that Texas has no means to evaluate the models themselves. Hurricane models are highly complex, proprietary products that incorporate the expertise of engineers, meteorologists, statisticians, actuaries and other experts. Even if the modelers were willing to provide any of the models' proprietary underpinnings, the state has no panel competent to evaluate them. Florida, for example, created the Florida Commission on Hurricane Loss Methodology<sup>1</sup> to review and evaluate hurricane models. This panel is comprised of the relevant experts in different fields necessary to evaluate the models.

Texas could create a similar panel. The pool of experts at Texas universities would be a good start in developing the organization. Additional resources could be added through a number of state agencies. Though the models are presently perceived as a coastal matter, this is changing quickly. Insurance companies, in greater numbers, have begun adopting tornado/hail and winter storm models. The use of these models will have a strong effect on areas of the state such as the Panhandle, the DFW area and north Texas. The wind/hail and winter storm models are not subject to review anywhere and are less refined than the hurricane models because of their short history of use.

Another option to consider, beyond developing a more sophisticated review mechanism for the models, would be the development of a transparent, corroborating model in the public domain. Florida has developed and used such a model for many years. Despite criticism, over time, the public model does not consistently yield lower results than the commercial models. It is however, fully transparent and thus, not a black box. The development of a public model could be done in conjunction with or completely independent of the formation of an expert review panel.

With respect to reinsurance arrangements, these too must be subject to full evaluation by regulators. This evaluation should include the terms, amount, rationale for, and the parties to the purchase. Increasingly reinsurance purchases appear to be made as a tool to smooth earnings

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<sup>1</sup> The Commission is administratively a part of the Florida Catastrophe Trust Fund and is managed by the State Office of Administration. The Trust Fund functions as a reinsurer to the residential property insurance industry.

patterns for the insurer. Additionally, some purchases have an extremely low recovery rate (less than 20%) and are placed to reinsure risks typically retained by the insurance company. Finally, some purchases are made from affiliated companies. This begs questions concerning proper risk diversification and transactions made at less than arm's length.

The industry asserts that reinsurance agreements often contain proprietary information so disclosure would place them at a competitive disadvantage. This concern is valid in some cases. At present, Texas law is in conflict concerning whether all elements of rate filings are public information. To resolve this, the industry and regulators need additional statutory clarity concerning the issue. In addition to enhancing regulatory review and protecting proprietary information, a resolution would avoid expensive litigation that frequently results from disputes concerning what is and what is not proprietary information.

### 3. Encourage Effective Consumer Participation in the Marketplace

Consumers rarely shop their policies. According to a 2010 report by Deloitte Research, 42% of homeowner's policyholders have been with their company over ten years. Almost 60% of policyholders say they rarely or never shop their policy for a better deal. A variety of reasons are offered for the high level of retention. Many consumers lack basic knowledge about insurance and do not have much confidence that they can choose a better product than they already have. Other consumers find the process tedious. Also, bundled pricing requires consumers with multiple policies to shop them all. Mortgage escrows further complicate the issue. In addition, surveys suggest that nearly all major carriers boast high satisfaction rates. Consumers may also have a good relationship with their agent. Whatever the reason, high retention exists and less than 10% of consumers say they are likely to switch companies.

If customer retention is based on the quality of the product/services and price, the market operates properly. However, that is not always the case. Instead, when other factors (lack of knowledge, etc.) are discouraging consumers to shop, consumers are not moving to insurers that would offer better services/products at the same or a better price. This not only keeps the market from operating optimally, it also negatively impacts the consumer.

There are various ways to encourage insurance shopping. At OPIC we have developed and promoted an interactive policy comparison tool that has been widely adopted by agents and

consumers. Along with TDI, we maintain Helpinsure.com that provides sample premiums for a limited number of insurers. Each of these tools, and the general services of TDI and OPIC, can be publicized more. Additionally, Helpinsure.com has not been updated in several years. Helpinsure could be revised to provide more accurate sample rates and generally to be more consumer friendly.

Even with high quality, well publicized tools, some consumers will still lack the confidence to shop. Given the amount of money spent on insurance premiums over a consumer's lifetime, basic knowledge concerning insurance is important. However, outside of a brief chapter on Texas auto insurance requirements required in driver's training, young people are largely uneducated on the subject. If schools are amenable to the idea, learning modules could be provided to fill this obvious gap. Focused outreach should also be considered to engage future insurance buyers.

## ENSURING FAIR PRACTICES

### 1. Protect Consumers by Consistently Punishing Violators/Increasing Clarity

Strong, consistent punishment by the regulator of the insurance companies that violate the law to the detriment of consumers is essential. It is also important to resolve consumer complaints in a fair and consistent manner. A particular issue has been the coding of unresolved complaints. Recently the TDI Complaint Stakeholders Group (including representatives from insurance companies, insurance agents, consumer advocacy groups, TDI, and OPIC) provided feedback to TDI regarding a new rule dealing with coding of the complaints TDI receives from the public. A much improved rule was published in the Texas Register for consideration and adoption.

### 2. Increased Publication of Consumer Rights

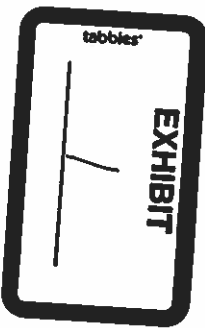
OPIC drafts Consumer Bills of Rights for homeowners, dwelling, and renters insureds. These documents include a summary of important consumer rights and are distributed by law with insurance policies. Some consumers overlook the bill of rights when it is sent and many people simply do not know that they exist. OPIC believes that additional media exposure would be helpful in reminding consumers of their rights under Texas law. At present, OPIC is

designing a media campaign to publicize the resulting bills of rights that are set to be approved by TDI the near term.

#### USE OF CUSTOMER INQUIRIES IN RATING AND UNDERWRITING DECISIONS

The industry asserts that there is a positive correlation between customer inquiries and claim filing behavior. Irrespective of the existence of a correlation, which may exist, there is a public policy issue that must also be considered. Should we allow the use of a rating factor that will likely have a chilling effect on consumer inquiries of their insurer that do not result in a claim being filed? This places the consumer in the unfortunate position of being punished for asking a question. Such a practice would thwart a consumer's ability and desire to understand the insurance product they purchased. Additionally, out of fear of higher rates, some consumers would not contact their insurance company and inquire about a valid claim. This was partially addressed by the 82<sup>nd</sup> Legislature when reports to a claims database were prohibited when no claim is filed (please see TEX. INS. CODE §563.002). However, §563.002 does not bar an individual insurer from using the inquiry for a rating or underwriting purpose. Thus, the issue remains. For these reasons, OPIC contends that the protections of §563.002 should be expanded to ban the use of customer inquiries in underwriting and rating decisions by the insurer.





# Trend Toward Lower Coverage

Increasing Deductibles (Especially for Wind/Hail)

Tier 2	% of Total HO Policies					
	2005	2006	2007	2008	2009	% Chg 05-09
Wind Ded						
< 1%	16.2%	14.0%	7.0%	5.7%	4.6%	-71.9%
1%	62.5%	64.8%	65.7%	60.3%	52.3%	-16.3%
2%	18.6%	18.2%	22.2%	27.5%	35.5%	91.1%
> 2%	1.3%	1.4%	3.1%	4.5%	5.5%	314.3%
2% or Greater	19.9%	19.6%	25.3%	31.9%	41.0%	106.0%

Tier 2 consists of the layer of counties geographically behind the Tier 1 coastal area. This includes Harris County (Houston).

# Profitability Picture Since File and Use

Texas Financial Statement Data			
	Earned Premium	Incurred Losses	Loss Ratio
2004	4,361,635,314	1,213,088,301	27.8%
2005	4,610,859,573	2,609,419,843	56.6%
2006	4,604,385,162	1,566,429,126	34.0%
2007	5,000,782,866	1,820,164,762	36.4%
2008	5,224,968,126	6,742,744,446	129.0%
2009	5,435,727,942	3,652,905,485	67.2%
2010	5,718,375,100	2,793,093,954	48.8%
2011	5,877,532,348	4,202,037,831	71.5%
Total / Avg.	40,834,266,431	24,599,883,748	60.2%

Source: Financial Statement State Page Data (Texas) Reported to NAIC