



Texas Department of Insurance

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October 4, 2012

Members of the Senate Committee on Business and Commerce
P.O. Box 12068
Capitol Station
Austin, Texas 78711

RE: TDI's Supplemental Report on Homeowners Expenses

Dear Members of the Committee:

Enclosed is TDI's Supplemental Report on Underwriting Expense Differences in Homeowners Insurance. This Supplemental Report is a follow-up to the report I presented at the July 10, 2012, meeting of the Senate Committee on Business and Commerce. During that meeting, committee members asked me to investigate why Texas has high underwriting expenses compared to other states. The purpose of this supplemental report is to provide you with the answers to that question.

Please let me know if I can provide any additional information or if I can be of further assistance.

Very truly yours,

A handwritten signature in cursive script that reads "Eleanor Kitzman".

Eleanor Kitzman
Commissioner of Insurance

2012

Supplemental Report to the Senate Business and Commerce Committee

Underwriting Expense Differences in Homeowners Insurance

A review of underwriting expense differences in homeowners insurance in
Texas and other states.

Texas Department of Insurance

October 1, 2012



Background and Purpose

In our July 10, 2012, report to the Senate Business and Commerce Committee, TDI made the following findings related to underwriting expenses in Texas homeowners insurance.

- The actual historical average underwriting expense components since 2000 shows that Texas' average policy acquisition expense is 65 percent higher than countrywide; the average general expense is 43 percent higher than countrywide; and the average premium taxes, licenses, and fees expense is 47 percent higher than countrywide.

Average Underwriting Expense Components Texas and Countrywide

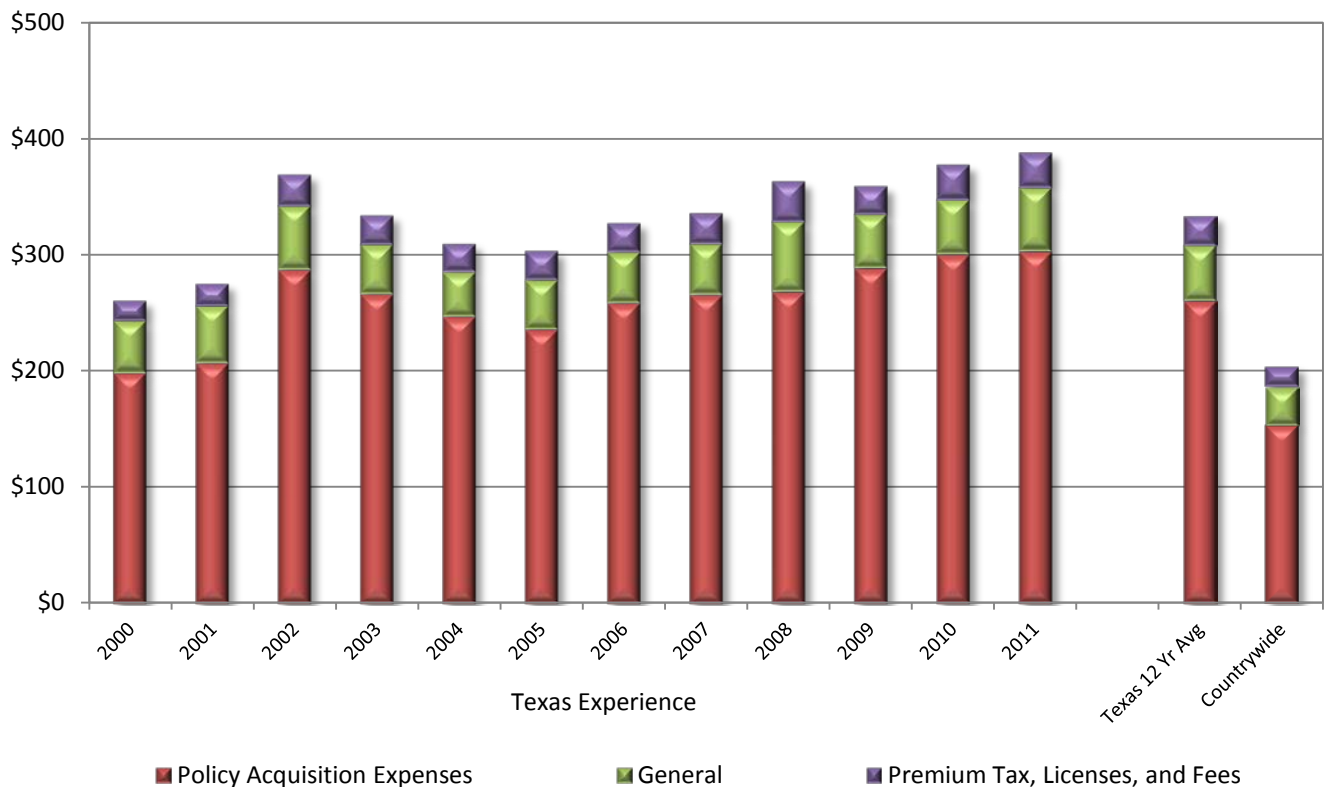


Figure 1. Average underwriting expenses per policy in Texas from 2000 to 2011 for all owner-occupied homeowners' policy forms. Countrywide average from 2000 to 2009.

Source: Texas compilation of Annual Statement Page 14 data from 2000 to 2011; 2000 to 2009 NAIC profitability reports.

- The amounts paid for underwriting expenses in Texas have increased over time. From 2000 to 2011, the average commission expense increased 61 percent; the average other acquisition expense increased 41 percent; the average general expense increased 21 percent; and the average premium taxes, licenses, and fees expense increased 75 percent.
- Part of the increase in the expenses is due to certain expenses being a percent of premium, such as agents' commission. As the average premium increases, expenses that are a percent of premium will automatically increase by the same amount.

That report also compared the dollars of acquisition expenses among all 50 states. Acquisition expenses are commissions and other expenses associated with issuing insurance policies (see Appendix for a description of expense categories). The report found a strong relationship between states with high average premiums and high average acquisition expenses per policy.

2009 Average Commission and Other Acquisition Expense per Policy

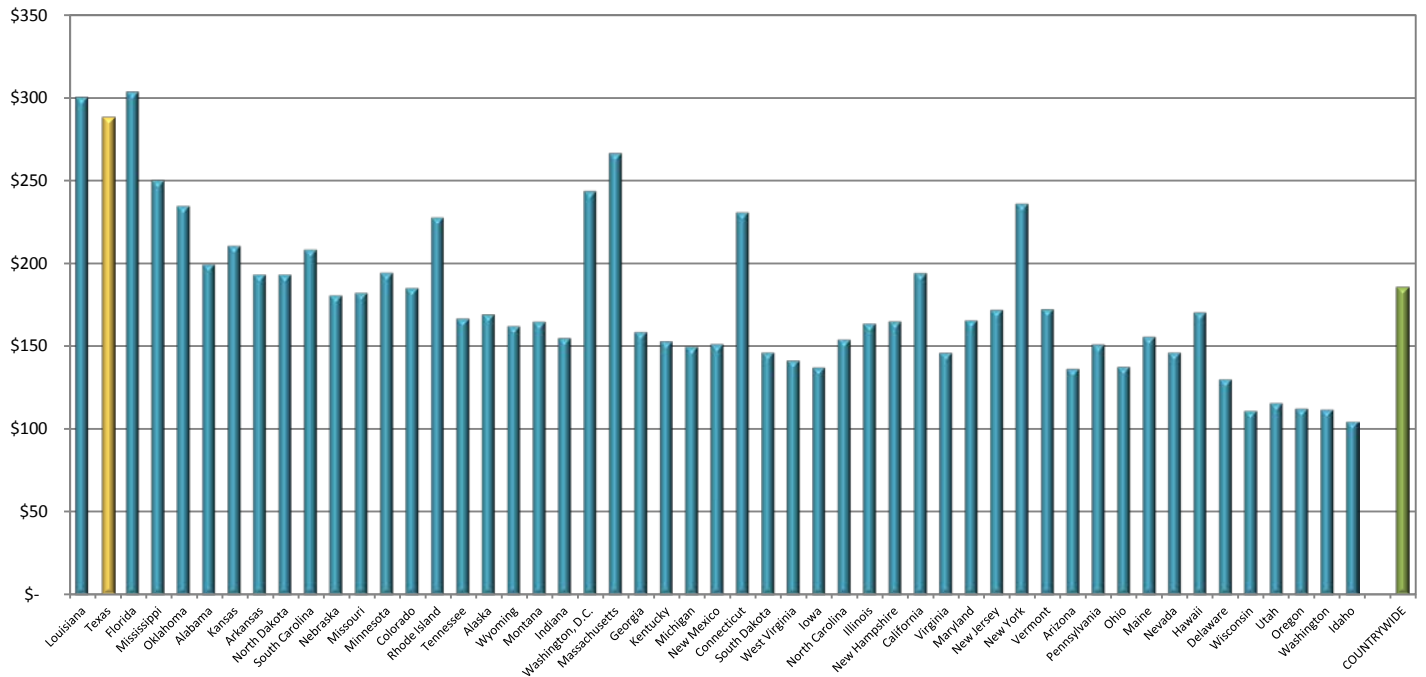


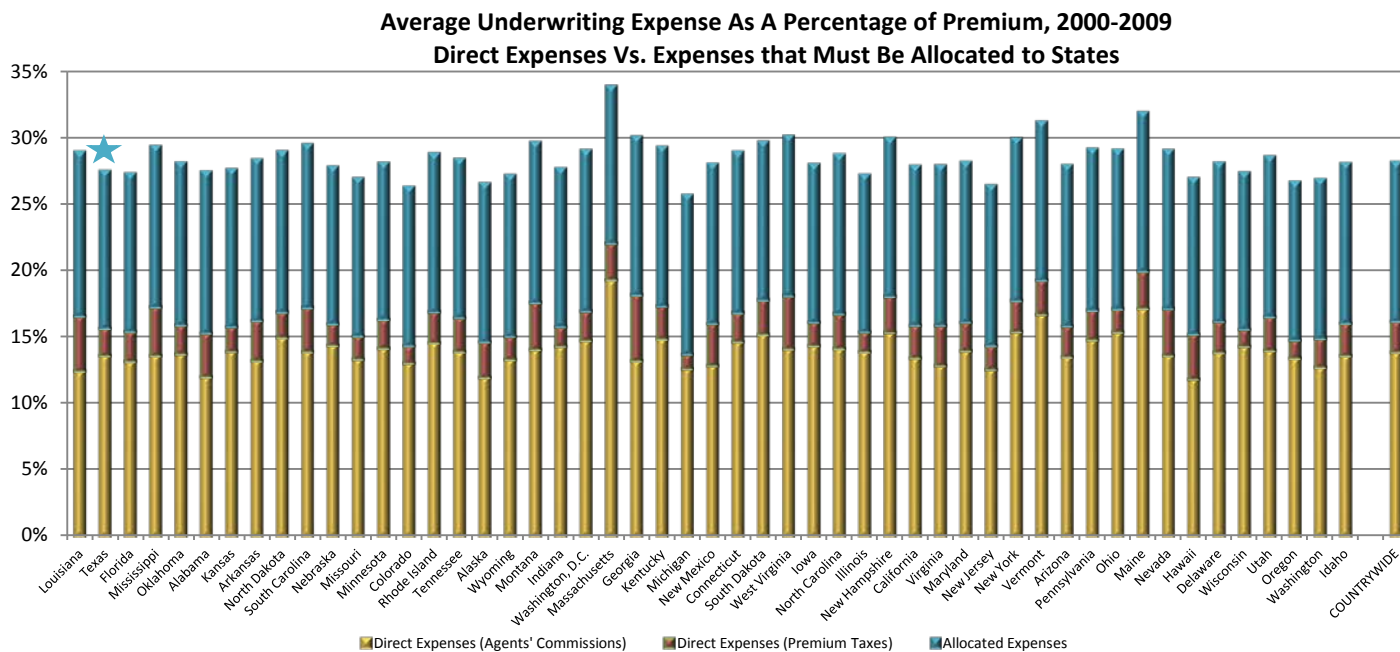
Figure 2. 2009 average homeowners commission and other acquisition expense per policy for all policy forms combined for all coverage amounts. States are sorted based on the 2009 average homeowner premium per policy for coverage amounts in the range \$175,000 to \$199,999.

Source: 2009 NAIC report on average premium and 2009 NAIC profitability report.

Members of the Senate Business and Commerce Committee asked TDI to investigate why Texas has such high underwriting expenses compared to other states. TDI staff reviewed the most recent 10 years of expense data available (2000 – 2009) for all 50 states to explain why Texas has such high average underwriting expenses. The Department’s findings are contained within this supplementary report.

Key Findings

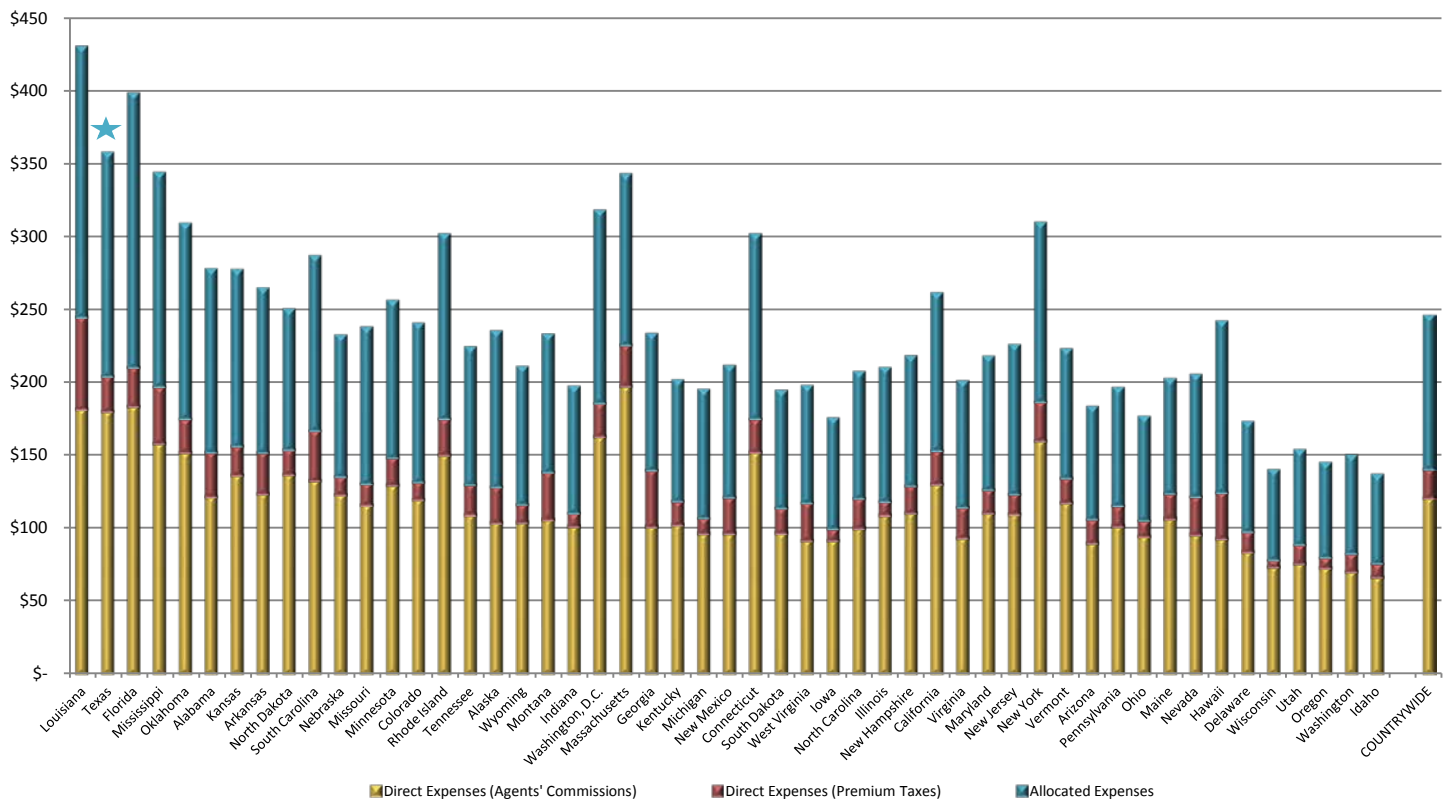
- Only certain types of underwriting expenses can be determined for an individual state. These expenses are *agents' commissions* and *premium taxes, licenses, and fees*. Other acquisition expenses and *general expenses* cannot be determined directly for an individual state. These expenses must be estimated for individual states using an allocation formula. Underwriting expenses that can be directly attributed to an individual state account for about 57 percent of the total underwriting expenses.



- Underwriting expenses that insurers can directly attribute to an individual state are expenses that vary directly with the amount of premium. These expenses are high in Texas because Texas has a high average premium per policy.
 - Insurers pay their agents a percentage of the gross premium to sell insurance policies. For example, an insurer may pay its agents 10 percent of the insurance premium to sell the insurer's homeowner policies. If a state has an average premium of \$500 per policy and an average commission rate of 10 percent, then insurers pay their agents an average of \$50 per policy. If a state has an average premium of \$1,500 per policy and an average commission rate of 10 percent, then insurers pay their agents an average of \$150 per policy.
 - A large majority of premium taxes, licenses, and fees vary directly with gross premium. All states charge insurers premium taxes that are a direct percentage of the gross premium. If a state has a premium tax rate of 2 percent and an average premium of \$500 per policy, then insurers must pay the State an average of \$10 per policy. If a state has a premium tax rate of 2 percent and an average premium of \$1,500 per policy, then insurers must pay the State an average of \$30 per policy.
- TDI's source for multi-state expense data (the *NAIC Profitability Report*) allocates underwriting expenses that insurers cannot attribute to individual states. The allocation formula used by the NAIC assumes all underwriting expenses vary directly with premium. States, like Texas, with a high average premium per policy will show a high average expense per policy regardless whether these states have a higher cost per policy.
- Texas' high average homeowner premium relative to the national average explains most of the difference in average expenses in Texas vs. the national average.
 - For *agents' commissions* and *premium taxes, licenses, and fees*, the higher average premium in Texas causes higher average insurer expenses, since these expenses are a percentage of the premium.

- For *general expenses* and *other acquisition expenses*, the higher expense per policy is mostly due to an allocation formula, and not due to measurable higher expenses in Texas. However, since we cannot directly attribute these expenses to individual states, we cannot rule out the possibility that average general and other acquisition expenses per policy may be higher in Texas than in other States.

Average Underwriting Expense Per Policy, 2009
Direct Expenses Vs. Expenses that Must Be Allocated to States



- For *agents' commissions* and *premium taxes, licenses, and fees*, growth in the average premium per policy explains most of the growth in the average expense per policy for Texas and nationwide.
- Differences in the sources of expense information used by TDI to compare Texas vs. other States caused minor differences in the expense ratios. However, these differences were small when compared to differences caused by the difference in the average homeowners' premium in Texas versus countrywide.
 - For *general expenses* and *other acquisition expenses*, in the case of Texas, the department gave each insurer's expense ratio a weight equal to its homeowners' market share in Texas. In the case of other states, the NAIC gives each insurer's expense ratio a weight equal to its national homeowners' market share.
 - For *general expenses* and *other acquisition expenses*, in the case of Texas, the department used earned premium as the denominator. In the case of other states, the NAIC used $[(\frac{1}{2}) \times (\text{Earned Premium} + \text{Written Premium})]$ as the denominator for *general expenses*, and written premium as the denominator for *other acquisition expenses*.

Appendix – Expense Definitions

Agents' Commissions are compensation paid to insurance agents for selling insurance policies on the insurer's behalf.

Premium tax, licenses and fees are amounts insurers pay to state and local governments as taxes. It also includes other costs imposed by state and local governments, such as maintenance taxes, filing, and licensing fees. This category of expense does not include federal income taxes. The majority of the expenses in this category are for state premium taxes, which all 50 states in the U.S. impose on insurers.

Other acquisition expenses are costs related to the production of new and renewal insurance business, other than compensation to insurance agents. This category includes the cost of underwriters who determine whether to issue an insurance policy, advertising costs, data processing for issuing new and renewal policies, postage costs, and salaries related to these functions, including the cost of related administrative support staff.

General expenses are other expenses not associated with policy acquisition, claims adjusting, or investing. It may include such things as executive expenses, certain home office expenses, and expenses for functions such as human resources, accounting, and actuarial.