Property Casualty Insurers Association of America

Shaping the Future of American Insurance

TEXAS SENATE BUSINESS & COMMERCE COMMITTEE HEARING TESTIMONY

TUESDAY, JULY 10, 2012

PCI STATEMENT REGARDING
A BROAD REVIEW OF
THE TEXAS HOMEOWNERS INSURANCE MARKET

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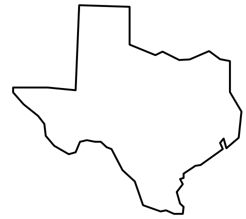

Summary of PCI Testimony

In response to the interim study charge of the Texas Senate Business & Commerce Committee to conduct a broad review of the homeowners insurance market, the Property Casualty Insurers Association of America (PCI) is pleased to submit the attached Special Report. This report, entitled "Analysis of the Texas Homeowners and Automobile Insurance Markets," examines the performance of both the homeowners and auto markets in the state.

In this analysis, homeowners and auto insurance premium comparisons are made between Texas and the national average. Cost factors underlying the state's premium levels are identified, providing greater insight into its relatively high prices. Although Texas prices are higher compared to most other states, they cannot be considered excessive since they appropriately reflect related high costs caused by external factors. If anything, homeowners' rates could be higher but their trends are found to lag behind rising home values and construction costs.

There are ways, however, that certain problems related to outside factors can be alleviated to lower costs and provide more affordable insurance for consumers. These suggestions are offered in this report. Finally, an overview of the Texas homeowners and auto residual markets, thoughts on accessing consumer information on rates and policy coverages, and legislative changes affecting the state's unique policy form and rate regulatory system are included as appendixes.

PCI would like to thank the Senate Business & Commerce Committee for holding hearings to study important homeowners and auto insurance issues affecting the citizens of Texas and for allowing us to present this Special Report on behalf of our members. We remain committed to working with Texas lawmakers and the Department of Insurance in enacting legislative reforms, if appropriate, improving consumer services and ensuring fair practices and access to insurance at affordable prices.

*The **Property Casualty Insurers Association of America (PCI)** is a trade association comprising more than 1,000 insurers of all sizes and types, representing 39.2 percent of the general insurance business and 41.2 percent of the personal lines business in the US. PCI members represent 33.7 percent of the Texas personal lines market.*

PCI

SPECIAL REPORT

Analysis of the Texas Homeowners and Automobile Insurance Markets

Prepared by the
Property Casualty Insurers Association of America

June 28, 2012

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Executive Summary

Texas has always stood out not just because of its size, history, geography and people, but because of its unique homeowners and auto insurance markets. Residents of this state pay among the highest homeowners and auto insurance prices in the nation, spending on average 4.7 percent of their household income for both types of coverage.[1] There are very valid reasons for Texas' high prices that reflect high claims reporting and high claims costs. Factors including particularly high exposure to severe weather events, high urban traffic congestion, high vehicle theft frequency and high numbers of DUI and staged accidents all contribute to significant insured costs. In fact, damage costs from natural catastrophes in Texas are so large that homeowners losses and expenses have far exceeded the related premiums collected by insurers.

This Special Report examines the performance of the Texas homeowners and auto insurance markets with particular focus on the price for insurance and underlying cost factors. Recommendations on cost containment to improve coverage availability and affordability for consumers are also offered. Overviews of both homeowners and auto residual markets – i.e., the Texas Windstorm Insurance Association and Texas Automobile Insurance Plan Association – are described in Appendix I. Finally, Appendixes II to IV include discussions on enhancing consumer awareness of insurance rates, Texas' unique set of insurance policy forms, and a chronology of the state's personal lines rate regulatory system.

Highlights of this PCI study include the following:

The Texas Homeowners Insurance Market

- Although Texas' average homeowners insurance rate per $1,000 of coverage has declined steadily since the mold crisis in 2002-2003, this state continues to compete with Louisiana and Florida for the nation's top spot in terms of the price paid.

- No doubt, a significant factor affecting Texas' very high homeowners premium is its vulnerability to extreme weather conditions. While other states have their share of weather-related events, Texas is exposed to nine different types of natural disasters (flash flood, hail, heat wave, hurricanes, ice storms, lightning, thunderstorms, tornadoes, and wildfires) – more than any other state. In nearly six decades, Texas has received the highest number of federal disaster declarations, 60 percent more than the second highest state (California).

- Wind and hail events are the most prominent types of peril impacting Texans; these causes of loss represent nearly two-thirds of all homeowners claims and total costs.

[1] PCI, based on National Association of Insurance Commissioners (NAIC) and US Census Bureau data

- The average homeowners claim cost in Texas has nearly doubled in size over the past decade. One factor that affects the claim cost and, hence, price paid by consumers is the amount of insurance purchased to cover the replacement values of homes and personal belongings. Despite rising insured home values in this state, Texans have seen their rates per $1,000 of coverage go down.

  Another factor affecting the cost of homeowners claims is the cost of construction. From 2000 to 2009, construction costs in the US have increased about 33 percent; in contrast, Texas' average homeowners insurance rate per $1,000 of coverage has decreased roughly 7 percent. The decline in rates, even after catastrophic events, indicates that Texas consumers have not received unfair price treatment from insurers.

- During the past 10 years, total losses and expenses associated with the homeowners coverage in Texas have exceeded the related premiums paid by policyholders, resulting in a $1.4 billion underwriting deficit. Even insurers' investments have not been able to make up for the shortfall to help pay for claims.

- The Texas homeowners market has improved over the years with more carriers offering residential property insurance. Despite the increase, however, the market is still "moderately concentrated" in terms of competing insurers. Greater competition is needed in this line in order to provide consumers a wider array of insurers, innovative products and more affordable prices.

The Texas Automobile Insurance Market

- Texas' average automobile full-coverage insurance premium (liability, collision and comprehensive coverages) is about 13.5 percent higher than the US ($1,022 – TX vs. $901 – US, per year). Average premiums for both collision and comprehensive in Texas are among the highest in the country, respectively 23 percent and 36 percent greater than the norm, while its average liability premium is similar to the norm.

- Texas' very high comprehensive premium is attributable to the preponderance of severe wind and hailstorms that damage vehicle bodies. Other factors affecting the state's high costs and, hence, premium are: a very high frequency of stolen vehicles and very high numbers of staged and DUI accidents; a higher-than-average rate of uninsured drivers; very dense urban traffic; and a large proportion of luxury cars that are more expensive to repair when damaged and more costly to replace.

- Unlike homeowners insurance, auto premiums collected by Texas insurers over the past decade have been sufficient to pay for related claims and other expenses. The result has been a $2.4 billion surplus, or a small underwriting profit of 1.0 percent of premiums. Texas' auto insurance profits which are similar to the national average are by no means excessive.

- Evidence of a healthy competitive auto market in Texas is strong. Firms can easily enter and exit the market; there are a sufficient number of carriers from which to select; and there are no dominant insurers that would attempt to set prices much higher than related costs or restrict the amount of products or services offered.

Suggestions to Improve Availability and Affordability of Coverage

- Homeowners and auto insurance prices are higher in Texas than in other states because they reflect underlying costs due to higher claim frequency and severity. Suggestions to lower costs and improve the availability and affordability of coverage are summarized below.

  Homeowners insurance

  - Encourage stronger enforcement of uniform statewide building codes that reduce the risk of injury or death during severe weather events.
  - Implement state grants for qualified mitigation improvements to encourage consumers to retrofit their homes against wind damage.
  - Adopt insurance fraud legislation that protects homeowners from contactor fraud and abuse and ensures that claims accurately reflect the true cost of property damage.

  Auto insurance

  - Have the Texas State motor vehicle titling agency fully participate in the National Motor Vehicle Titling Information System to decrease vehicle theft and fraud.
  - Allow insurers sufficient time to investigate fraudulent injury claims resulting from staged or caused accidents, and the ability to conduct on-site inspections of health care clinics to ensure that their services are legitimate.
  - To lower the number of uninsured motorists, implement online identification programs that track motorists previously ticketed or convicted of driving without insurance. In addition, adopt a no-pay/no-play system that takes away the uninsured driver's right to sue for pain and suffering if he or she is hurt in an auto accident and impose mandatory fines – that cannot be reduced by judges – for violating the compulsory liability law.
  - To reduce accidents involving drinking and driving, have interlock devices installed in cars of all motorists with DUI convictions.

Modernize the Personal Lines Rate Regulatory System
Texans can greatly benefit from a more effective and efficient rate regulatory system that allows market forces to influence rates. As seen in other states, modernizing the rate regulatory system and reducing the number of forms that must be filed can result in lower premium increases, or possible decreases, and attract more insurers that provide greater choices for the public. Such a plan can be readily implemented in this state without harming consumer protection.

Texas Residual Markets (Appendix I)

- Heavy migration to the Gulf Coast has led to a significant increase in policies and insured coastal values written by the Texas Windstorm Insurance Association. Over the years, more forceful storms have greatly impacted coastal properties and TWIA's sustainability. With an ill-designed funding mechanism, TWIA has had to rely heavily on the private market, creating serious market disruptions. Although TWIA is far from being financially sound, positive steps were recently taken in the form of two laws (HB 4409 and HB 3, passed in 2009 and 2011) to help pay for future hurricane losses and encourage more insurers to write homeowners business.

- The Texas Automobile Insurance Plan Association is operating as intended as the "insurer of last resort." The market share exhibited by TAIPA is lower than the countrywide average and has gradually declined over the years, indicating that auto insurance is readily available through the voluntary market.

Enhancing Consumer Awareness of Rates and Coverages (Appendix II)

- The Texas Department of Insurance website, www.helpinsure.com, likely has the most effective and efficient online homeowners and auto rate and coverage guides compared to all other states. In order to keep consumers better informed and to attract more users, the TDI might consider utilizing social media (e.g., Facebook or Twitter).

- Encourage Texas State and local offices to include in their public communications reminders about the benefits of shopping around for the best insurance rates and coverages that suit individual and household needs.

The Evolution of Texas Policy Forms (Appendix III)

- For many years, the same standard homeowners and auto policy forms developed by the Texas State Board of Insurance (now the Texas Department of Insurance) were required to be used by all insurers. The forms have evolved over time:

  - In 1991, national organizations of insurance companies were allowed to develop their own homeowners and auto forms and use them with regulatory approval. However, the coverage offered had to be at a minimum “equivalent” to the coverage provided under the State Board-promulgated forms.

  - In 1997, national insurers were permitted to develop their own *homeowners* policy forms. The “equivalent” coverage requirement was removed, further allowing companies to file for approved endorsements that could either enhance or restrict coverage provided in State Board-promulgated forms.

  - In 2003, Senate Bill 14 passed, which among other items, enabled *all* insurers – regardless of size – and advisory organizations to file their own homeowners and auto policy forms and endorsements with no minimum coverage requirement. These forms and endorsements still require regulatory approval.

- In homeowners insurance, the most commonly purchased form was HO-B which specifically excluded certain perils including mold, fungi, etc. A mold crisis emerged in the early 2000s which prompted the courts to interpret contract language requiring insurers to pay for mold-related claims despite the policy exclusion. Consequently, more than half (51 percent) of the total homeowners premiums collected went to cover mold losses. Since insurers were now being forced to pay for this particular peril – which was not initially part of the policy coverage – many insurers had no choice but to drop the HO-B policy or dramatically raise their rates to cover the excessively growing numbers of mold claims.

  In an effort to stabilize the homeowners market, the TDI ordered the elimination of mold testing and remediation from all homeowners policies which caused some to allege that policyholders were “paying more for less coverage.” This is *not* the case, however, as the TDI reported a 13.5 percent *reduction* in rates resulting from the decline in mold coverage.

- For years, the standard Board-promulgated policy forms eliminated an important element of competition within the industry to better serve the market. Since insurers could not develop their own forms and be innovative to respond to customers’ needs, Texas policyholders had very few options in the type of protection needed; they also were unable to receive the same benefits granted to policyholders in other states. Furthermore, the inability to compete on forms caused many insurers to withdraw from the market. Since competition brings downward pressure on prices, Texas consumers were hurt not only in terms of their ability to find coverage, but in their ability to pay lower prices.

Texas Personal Lines Rate Regulation: The Last 25 Years (Appendix IV)

- Prior to 1991, Texas promulgated homeowners and auto insurance rates which prohibited insurance companies from developing their own rating plans. Insurers were able to file for deviations, though, upon approval of the Insurance Commissioner. While rate regulation applied to most insurers, other insurers such as county mutuals, Lloyds insurers, reciprocal and interinsurance exchanges were exempt – creating an unlevel playing field.

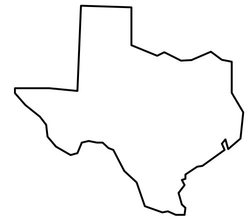
- In 1991, the Omnibus Insurance Regulation Bill passed which converted Texas' prior approval rating system to flex-rating using a State Board-developed "benchmark" rate and ±30 percent band. Under a flex system, insurance companies were able to file and use their rates immediately if their rate changes fell within the band; rates outside the band still required regulatory approval.

- Since non-rate-regulated insurers were still exempt under the 1991 bill, more regulated insurers created new unregulated subsidiaries and moved their customers to these particular firms. As a result, the vast majority of policyholders in both the homeowners and auto markets were written at unregulated rates.

- Senate Bill 14 was a comprehensive bill that passed in 2003, bringing sweeping changes to the personal lines market. Two major changes included: replacing the flex-rating system with a file-and-use system, effective December 1, 2004 (there was an interim prior approval period); and removal of the county mutual, Lloyds, etc. exemption, making these insurers subject to rate regulation now.

- Under today's file-and-use rating system, an excessive number of forms are required to be completed. Instead of the enormous effort made by the TDI to contest and review rate filings, their valuable time (which tends to be limited) could be used more effectively in overseeing necessary consumer protection functions, i.e., insurers' financial performance and marketplace conduct.

- Texas' current rate filing process does not need to be an unpredictable one, making companies feel they are at a greater risk of having to defend their actions. As a result of the regulatory time lag, companies have delayed implementing their rates so that they are no longer accurate in reflecting projected conditions. Regrettably, today's rate environment for both homeowners and auto lines has not seen the competitive benefits as expected.

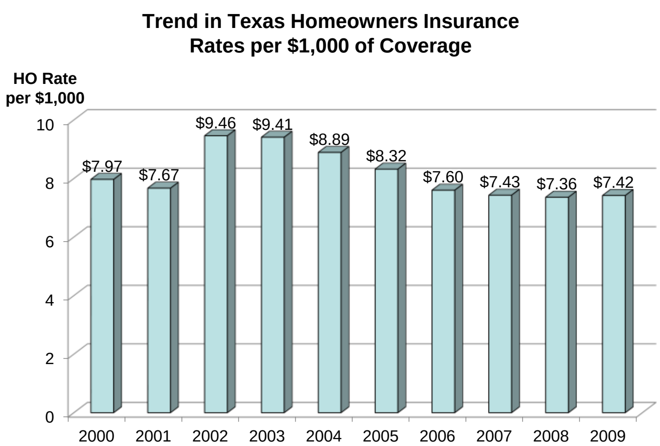


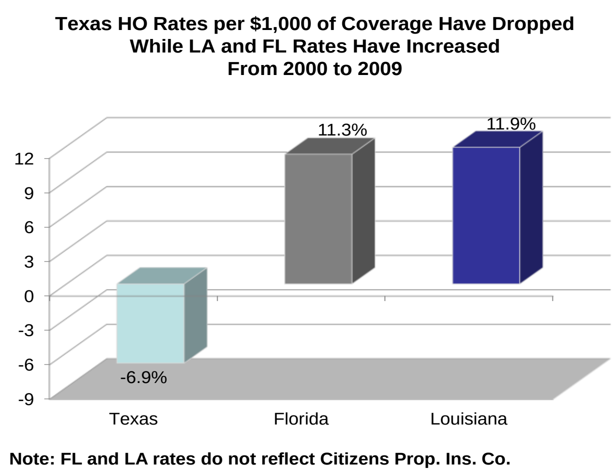
The Texas Homeowners Insurance Market

Texas' Homeowners Insurance Prices Have Declined

Texans continue to pay one of the highest – if not the highest – prices for homeowners insurance coverage in the US. This was especially true during the early 2000s when the mold crisis emerged; mold was the most severe cause of insured loss representing 51 percent of premiums in 2002. Since that time, Texas' rate per $1,000 of coverage has dropped almost 22 percent; it is now lower than what it was at the beginning of the decade.[2]

For years, Texas has competed with Florida and Louisiana for the number one spot in insurance price. For every $1,000 of coverage, Texas' rate for homeowners insurance peaked in 2002 and was highest in the nation (per $1,000 of coverage: $9.46 – TX compared to $7.74 – LA and $6.09 – FL). From 2002 to 2009, Texas' rate has dropped 6.9 percent, while Florida and Louisiana's rates have increased 11 to 12 percent.[3]





Heavy Coastal Migration and More Severe Catastrophes Continue to Affect Texas

A discussion of homeowners insurance in Texas would not be complete without mentioning two significant ongoing occurrences impacting the people of this state – heavier migration to the water and more severe catastrophes.

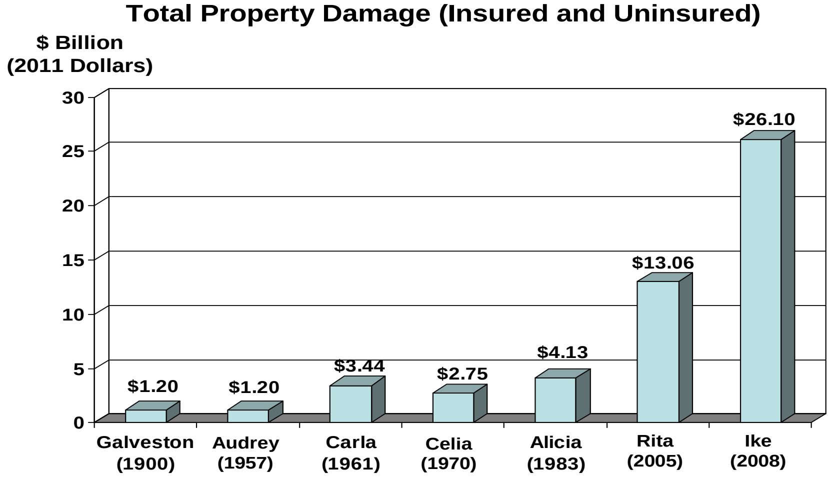
[2] PCI, based on data from National Association of Insurance Commissioners (NAIC), *"Dwelling Fire, Homeowners Owner-Occupied, and Homeowners Tenant and Condominium / Cooperative Unit Owner's Insurance: Market Distributions and Average Cost by Policy and Amount of Insurance"* reports.

[3] Rates for Florida and Louisiana do not include data for their Citizens Property Insurance Company, the two states' "insurer of last resort."

About 5.9 million people are now living in the state's coastal areas, having increased two-and-a-half times since 1960. Unlike declines in other states, Texas markets along the water have seen recent positive growth in median home values from 2010 (4th qtr.) to 2011 (4th qtr.): e.g., Houston-Baytown-Sugar Land (1.2 percent) and Corpus Christi (0.7 percent). The large migration to the Gulf and higher home values mean higher insured coastal property values, which in this state were $895 billion in 2007. In all of Texas, its insured property value totals roughly $3.5 trillion.[4]

As a result of greater relocation to the coast, rapid shoreline development and more expensive infrastructure, stronger and more frequent windstorms have elevated the homeowners risk. Indeed, economic losses from hurricanes affecting not only Texas but all coastal regions and other parts of the country have increased sharply in the recent past.

Hurricanes Making Landfall in Texas
Total Property Damage (Insured and Uninsured)



Note: The above amounts represent losses for all affected states.

Along with hurricanes, Texas faces growing exposure to other severe catastrophic occurrences including tornadoes, wildfires, and even violent thunderstorms. In fact, strong thunderstorms – with damaging winds and hail – create the majority of Texas' weather events. According to *USA Today*, Texas has the most severe weather in the country, being exposed to nine different types of natural disasters,[5] more than any other state. Texas had more than 1,500 severe weather-related reports in 2011 – third highest in the nation.[6]

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[4] US Census Bureau; National Association of Realtors, "Top 10 Markets for Home-Price Growth in Q4 2011;" and AIR Worldwide Corporation; only Florida ($2.5 trillion) and New York ($2.4 trillion) have more *coastal* property exposed to storm loss

[5] The nine different types of natural disasters are flash flood, hail, heat wave, hurricanes, ice storms, lightning, thunderstorms, tornadoes, and wildfires.

[6] National Oceanic & Atmospheric Administration's National Weather Service Storm Prediction Center

Over the past six decades, this state has had the highest number of Federal disaster declarations (331) in the nation, including major disaster declarations, emergency declarations and fire management assistance declarations recorded by the Federal Emergency Management Agency. Putting this in perspective, Texas surpassed California – which had the second highest number of declarations (208) – by almost 60 percent.

Weather-related storms have become more costly, too. Over the last five years, nearly 60 percent of all homeowners losses paid in Texas have gone to cover insured catastrophe claims.[7] In 2008 and 2009, this state had the highest insured catastrophe losses in the nation, exceeding a total of $14.1 billion.[8] Last year's insured losses are significant as well, given the wide array of natural disasters that took place here. Following are examples of major weather occurrences that wreaked havoc in Texas in 2011 and past years:[9]

- A persistent statewide drought in 2011 cost about $1 billion in insured loss, making this year the worst and most expensive in terms of wildfires. Spring wildfires in the western part of Texas resulted in more than 3 million acres of land burned and 200 homes and businesses ruined. In September, the Bastrop County Complex Fire destroyed over 1,600 homes at an insured loss of $530 million.

- Hurricane Ike (2008) – the nation's 6th most expensive weather event in terms of insured losses – cost $9.8 billion in Texas only and $13.1 billion in the entire US. Making landfall in Galveston, its heavy rains and powerful winds and flood waters resulted in extensive damage in Houston, the Bolivar Peninsula and other Gulf Coast towns. Even parts of the Midwest and the Ohio Valley and Great Lakes regions were affected by severe winds emanating from this hurricane.

- Hurricane Rita (2005) caused nearly $2 billion in insured property losses in Texas (less than a month after Katrina). Making landfall around Sabine Pass, Jasper County was largely affected by Rita, as were parts of Arkansas, Louisiana, Mississippi and Florida.

- The 1900 Category 4 "Galveston Hurricane" is the deadliest in US history, resulting in more than 8,000 fatalities and destroying half of the homes and buildings in this area. If this event occurred today, it would have caused $40 billion in insured losses.[10]

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[7] Fast Track Monitoring System, a publicly available report of loss trends prepared by Independent Statistical Service, Insurance Services Office, Inc. and National Independent Statistical Service

[8] Property Claims Service, a unit of the Insurance Services Office, Inc.

[9] Webinar: Munich Re, "US Natural Catastrophe Update," and Insurance Information Institute, "Market and Financial Impact of 2011 Catastrophe Losses," Jan. 4, 2012

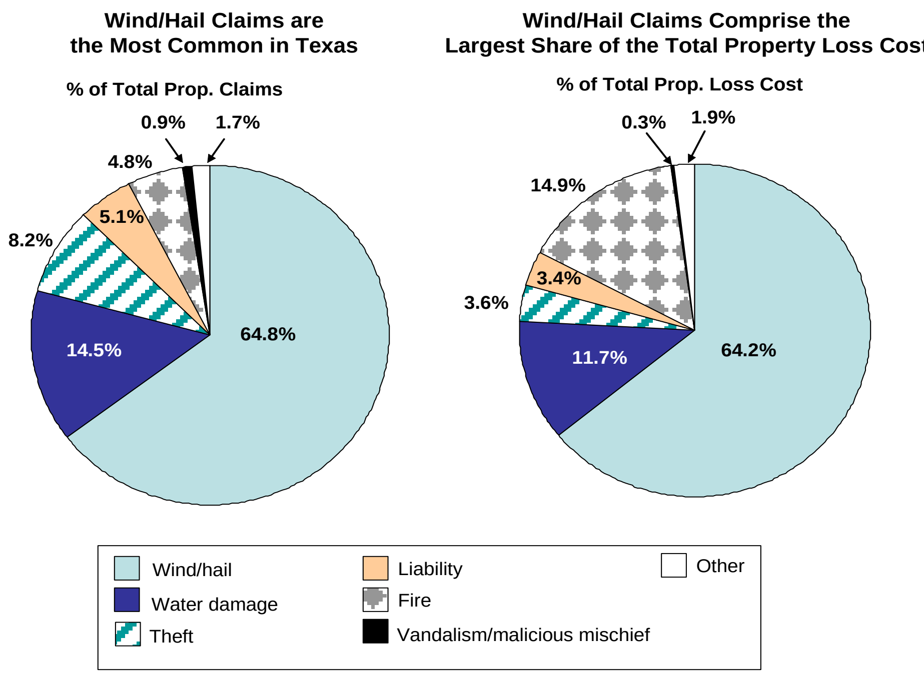
[10] The $40 billion loss is based on adjustments for inflation, growth in the number and value of coastal properties, and increases in property insurance coverage.

The Impact of Catastrophes on Texas' Insured Claims and Costs

This section examines two key components generally found in the insurance pricing equation: (1) the frequency of claims reported; and (2) the average cost of claims (i.e., the claim severity or average loss per claim). For homeowners coverage, the average claim frequency and claim cost make up the average loss per insured housing unit (*aka* the loss cost).

During 2006 to 2010, claims stemming from the wind and hail perils comprise about two-thirds (64.8 percent) of the total number of property insurance claims in Texas. The second most common type of claim stems from water damage (14.5 percent), followed by theft (8.2 percent), liability (5.1 percent), and fire (4.8 percent). Although fire claims are reported less often than other types of property claims, they are on average the most expensive in Texas ($21,155 per claim) – about three to nine times more costly than other claims.[11]

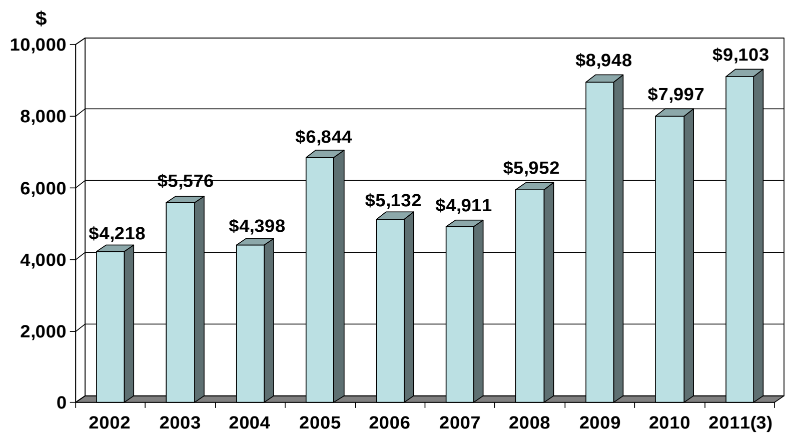
Combining the reporting frequency and cost of property claims together, wind and hail claims make up the largest portion of the total loss cost (i.e., insured loss per housing unit, 64.2 percent), followed by fire claims (14.9 percent) and water damage (11.7 percent). In other words, most of the homeowners insurance premium paid by Texas policyholders goes to pay for the cost of wind and hail damage.



[11] PCI, based on data compiled by the Texas Department of Insurance (TDI)

The average cost of a homeowners catastrophe insurance claim in Texas is now at a record-high level. From 2002 to 2008, claim severities (i.e., average claim costs) from natural disasters were in the $4,000-$7,000 range. Over the last few years, these costs have soared, now ranging from about $8,000 to $9,100.[12]

Texas Catastrophe Claim Costs
Have Doubled Over the Last Decade



It should be no surprise that more households throughout the entire nation are now obtaining higher amounts of insurance, given the higher replacement values of their homes[13] and personal belongings. The portion of Texans with insured homeowners policy limits of $200,000 or greater jumped from 10 percent to nearly 35 percent in the past decade. In 2000, the average insured value in the state was about $120,600 per policy; this average is now $210,000 per policy, rising 74.1 percent since the beginning of the decade.[14]

Another reason for Texas' higher homeowners claim costs is the rising construction cost to rebuild damaged homes and to replace items of like kind and quality. Construction costs influenced by the cost of materials and plumbing, electrical and mechanical work have gone up steadily over time throughout the entire country – increasing 32.6 percent from 2000 to 2009.

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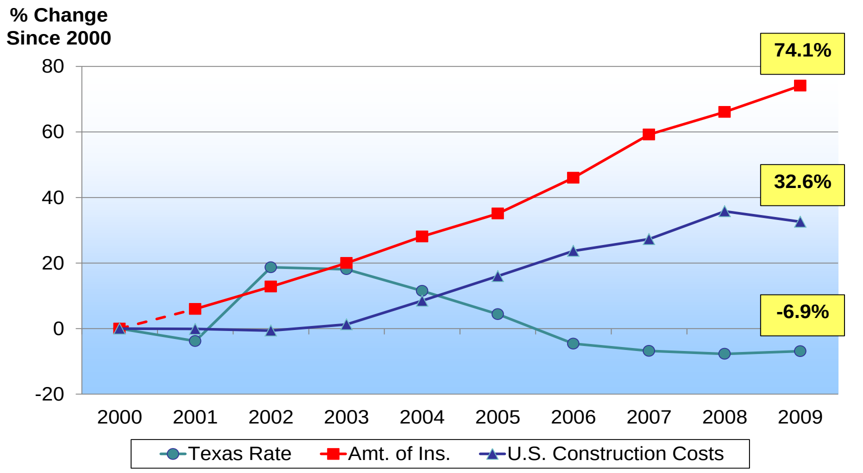
[12] Fast Track Monitoring System reports

[13] The median home price in Texas jumped 15.1 percent from $127,700 (2003) to about $147,000 (2010, preliminary). Source: Powerpoint, "Economic Outlook for Central Texas Real Estate," presented by James P. Gaines, Research Economist, Real Estate Center at Texas A&M University

[14] PCI, based on NAIC, *"Dwelling Fire, Homeowners Owner-Occupied, and Homeowners Tenant and Condominium / Cooperative Unit Owner's Insurance: Market Distributions and Average Cost by Policy and Amount of Insurance;"* figures do not reflect renters and condo-coop owners

Texas Homeowners Rates Have Generally Declined Despite Rise in Insured Values and Construction Costs



Notes: a) Data on rates reflect all Dwelling Fire and Homeowners Owner-Occupied policy forms.
b) The large increase in TX's avg. rates in 2002 and 2003 is due to the proliferation of mold claims, which subsequently subsided.

In spite of rising insured values and construction costs, the homeowners insurance rate per $1,000 of coverage have decreased 6.9 percent since 2000.[15] Given that Texas' average homeowners rates have lagged well behind the cost of construction – even continuing to fall after Hurricane Rita in 2005 – it cannot be said that Texans have been treated unfairly in terms of what they have been charged for their homeowners insurance.

Growing Homeowners Losses and Expenses in Texas Exceed Premiums

More costly damages caused by unprecedented natural disasters have become an even greater consideration in pricing decisions. Over the past decade, higher homeowners losses and loss adjustment expenses (LAE) to settle claims, combined with underwriting expenses to cover the cost of doing business in Texas, have surpassed the premiums paid by policyholders. In other words, the homeowners premiums collected by insurance companies have not been sufficient to offset total costs, especially during 2001-2002 and 2008-2009.[16]

Specifically, the total homeowners premiums collected by insurers in the private market were $48.5 billion during the period 2001 to 2010. In contrast, insurers have had to pay out slightly more money – almost $49.9 billion – to settle claims and take care of underwriting costs.

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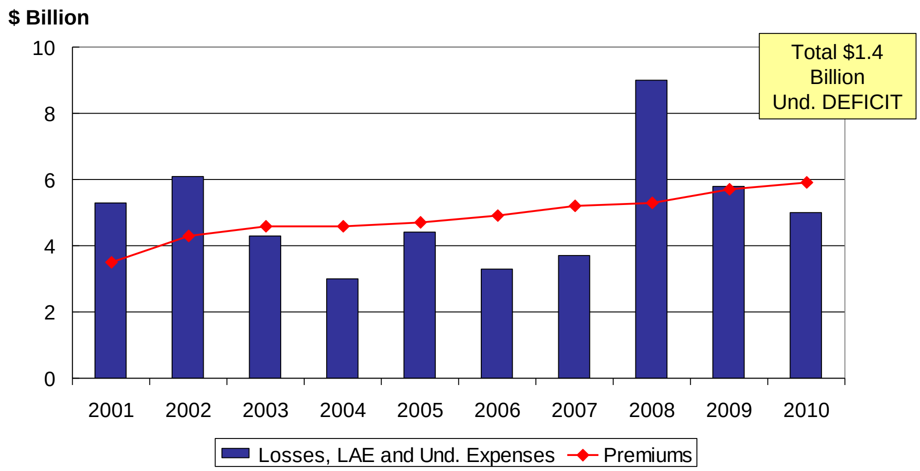
15 PCI, based on data compiled from US Bureau of Labor Statistics, Producer Price Index (Texas data are not available) and various NAIC homeowners reports on average cost and amount of insurance

16 PCI, based on NAIC data from SNL Financial LC; NAIC homeowners data do not include Texas Windstorm Insurance Association experience

What has resulted from this premium inadequacy is a total underwriting shortfall of $1.4 billion. Even insurers' investment income has not been large enough to help cover total costs over the past decade.

Texas Homeowners Insurers Have Not Collected Enough Premiums to Cover Losses and Expenses



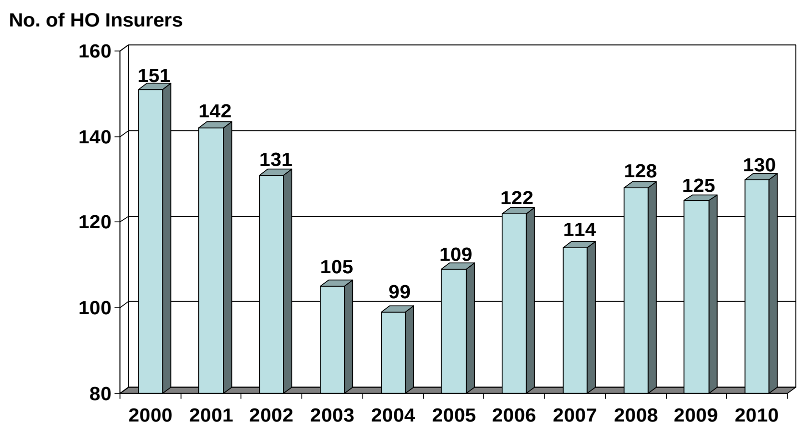
The Need to Strengthen the Texas Homeowners Market for Consumers

The heavy migration towards the water and unpredictability of costly natural disasters are making coastal exposures even more risky to insure now. Texas insurers need to re-evaluate their property business to ensure they have sufficient reserves so payments of claims can be made as promised when the next disaster occurs. In addition, they must continually demonstrate to rating agencies and investors that they are able to withstand extraordinary losses. Like most other businesses, insurers must show that they are financially solid and, hence, worthy of shareholders' capital. Without the necessary financial resources, insurers cannot remain viable in hazard-prone locations and provide high-quality and affordable coverage to meet the needs of current and future policyholders.

In order to mitigate their catastrophic loss exposures and ensure they have sufficient funds to pay claims and make their customers whole after a disaster, some property insurers have found it necessary to restrict their coverage or limit their writings; some have even withdrawn from the market. The large exodus during the early 2000s was due in part to a growing number of mold claims and growing exposure to natural catastrophes. However, it was also due to the unregulated market populated by Texas Lloyds companies; these insurers were allowed greater pricing freedom than in the regulated market, causing an unlevel playing field and a disadvantage to regulated insurers. (More about Lloyds companies is discussed in Appendix IV.)

The number of homeowners carriers has come back in recent years, but there are still about 20 fewer companies than a decade ago.[17] While the recent increase has improved the level of competition, the market is still moderately concentrated.[18] It needs to be stronger to give the public greater choices of carriers, innovative products and more affordable prices.

Texas Consumers are Now More Limited in their Choice of HO Insurers Compared to 10 Years Ago



[17] NAIC database from SNL Financial LC

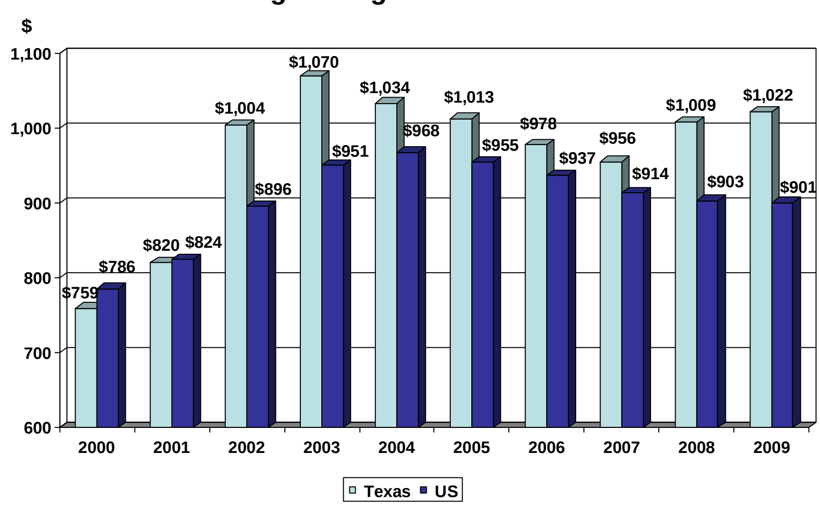
[18] Market concentration is measured by the Herfindahl-Hirshman Index, commonly used by the US Department of Justice. Texas' homeowners index value is just slightly more than 1,000, indicating a "moderately concentrated" market. Values of 1,000 or lower denote "low concentration," while values greater than 1,800 denote "high concentration;" higher indexes mean less competition.

The Texas Automobile Insurance Market

Texas' Average Auto Insurance Premium is Among the Highest in the US

On average, the price for full coverage automobile insurance in Texas (i.e., liability, collision and comprehensive coverages) is 12th highest in the nation.[19] Ten years ago, this state's average annual premium was less than the norm ($759 – TX vs. $786 – US), but its average premium is now about 13.5 percent higher than the norm ($1,022 – TX vs. $901 – US). Over the past decade, Texas' average combined price for the three major coverages increased 35 percent, 20 points faster than the national increase of 15 percent.

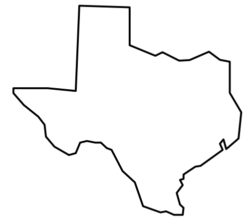
Texas' Average Annual Auto Premium is Among the Highest in the Nation



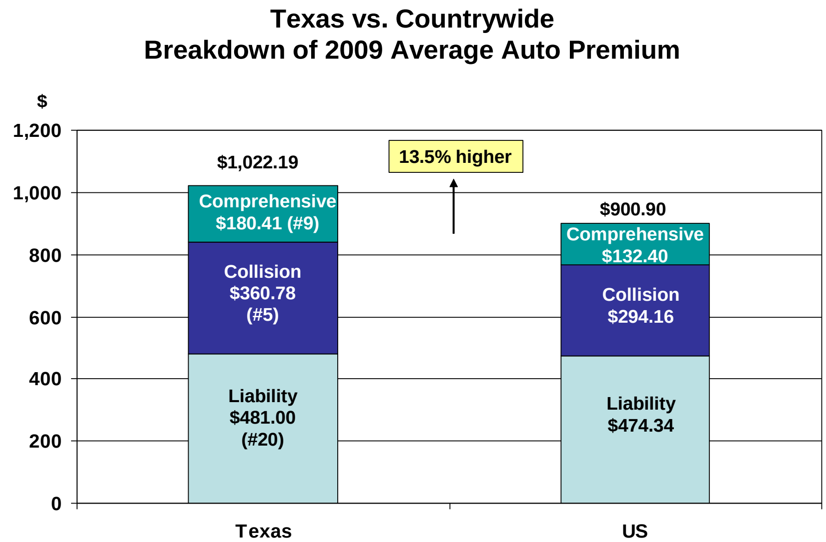
Texas' average liability premium[20] represents the largest portion of the total full coverage premium (47.1 percent), followed by the average collision premium (35.3 percent) and the average comprehensive premium (17.6 percent). The state's average liability premium is in line with the US norm – ranked 20th highest, it is only 1.4 percent greater than the mean. On the other hand, the average collision premium is 5th highest in the nation, 22.6 percent greater

[19] NAIC *Auto Insurance Database Reports* (latest data comparing Texas to the US reflect 2009) – note that the NAIC cautions readers about making comparisons of state rankings due to differences in state auto and tort laws, rate filing laws, traffic conditions, and other demographics.

[20] Liability includes bodily injury and property damage liability, medical payment, personal injury protection (PIP) and uninsured/underinsured motorist coverages. Texas is an "add-on" state whereby insureds may purchase additional first-party medical, wage loss and funeral PIP benefits; these added benefits do not restrict their ability to pursue a liability claim.



than the mean, while the average comprehensive premium is 9th highest, 36.3 percent greater than the mean.



A Comparison of Auto Insurance Losses by Coverage: Texas vs. US

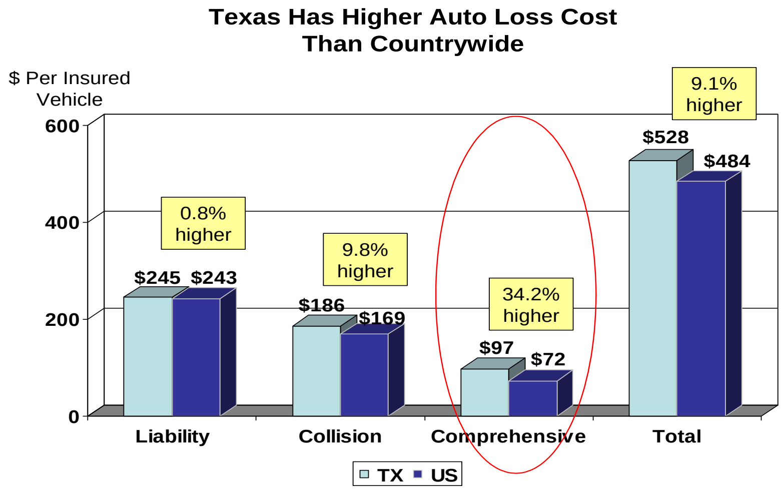
Insurance premiums are primarily a function of the number of claims reported and the cost of claims. For auto insurance, the claim frequency (i.e., the likelihood of a claim occurring) is usually given per 100 insured vehicles. The combination of the claim frequency and severity (i.e., average cost per claim) represents the loss cost, or loss per insured vehicle.

Texans pay more than average for their auto insurance because they tend to file claims more often and/or their claims cost more. The claim frequency and severity for each coverage vary in magnitude, affecting the relative disparity between Texas and the nation. Based on 2006 to 2011(3) data, the state's overall loss cost reflecting liability, collision and comprehensive coverages combined is about 9 percent higher than average.[21]

Although the average comprehensive premium represents the smallest part of Texas' total average premium, both the claim frequency and severity for this coverage show the greatest disparity between the state and countrywide. Not only are comprehensive claims reported about 8 percent more often in Texas, but they cost 25 percent more as well. These two variables combined result in a 34 percent differential in comprehensive loss cost between Texas and the national norm. That is, Texans are found to be one-third more risky when it comes to hail damage, fire, theft, vandalism, and other non-collision vehicle damage claims.

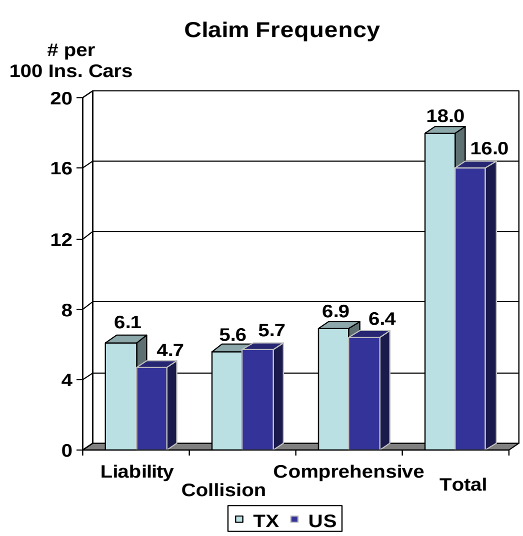
[21] Fast Track Monitoring System; unlike the NAIC average premium, the Fast Track liability coverage does not include medical payments and UM/UIM.

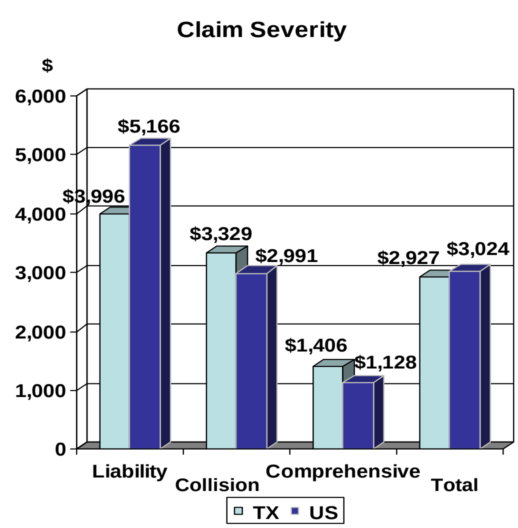
As for the other two coverages, Texas' collision loss cost is 9.8 percent higher than the US average, while the liability loss costs for both Texas and US are virtually the same.



Note: Fast Track Liability = BI, PD and PIP only

Texas' higher collision loss cost is due primarily to its higher claim severity ($3,329 – TX vs. $2,991 – US); its claim frequency is the same as the US average. Texas' liability loss cost consists of a higher claim frequency (per 100 insured cars: 6.1 claims – TX vs. 4.7 claims – US) offset by a lower severity ($3,996 – TX vs. $5,166 – US).





Note: Fast Track Liability = BI, PD and PIP only

Deconstructing Texas Auto Losses: Identifying Key Cost Drivers

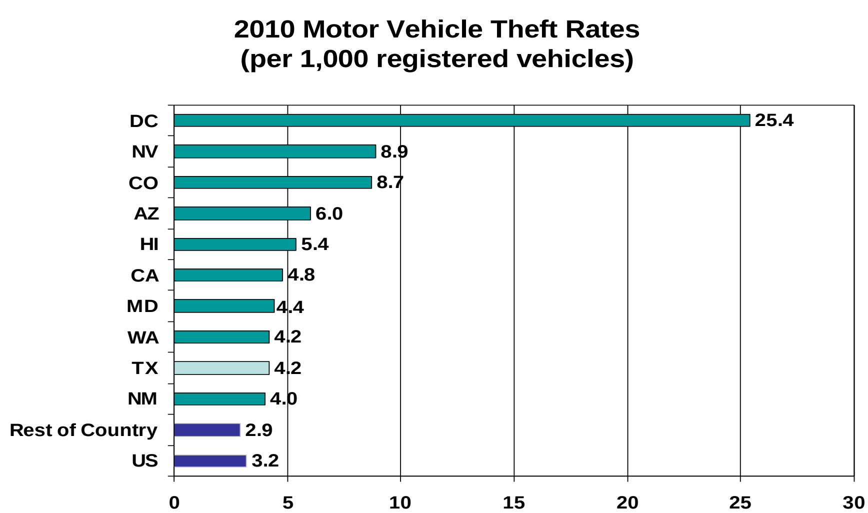
This section presents some of the key underlying reasons contributing to Texas' insured losses.

Preponderance of Severe Wind/Hail Storms

As mentioned in the Homeowners section, wind and hail perils comprise the largest and most costly portion of homeowners claims in Texas. These two weather events can do extensive damage to vehicles as well as homes. According to the Insurance Council of Texas, the line of thunderstorms that swept through south Texas in January 2011 resulted in $100 million of insured losses affecting cars, homes and businesses. In April of last year, Abilene experienced its most severe hailstorm which caused significant damage to hundreds of vehicles.[22]

Higher-than-Average Motor Vehicle Theft Rate

The comprehensive coverage also pays for insured vehicle thefts. In 2009, Texas had the 9th highest vehicle theft rate in the nation; for every 1,000 registered vehicles, Texans were 43 percent more likely to have their cars stolen in their home state than drivers elsewhere (4.2 vehicle thefts per 1,000 registered vehicles – TX vs. 2.9 vehicle thefts per 1,000 registered vehicles – Rest of Country).[23]



Higher Number of Staged/Caused Accidents

Texas is ranked 4th highest in the nation in terms of questionable injury claims resulting from staged/caused accidents (only Florida, California and New York are higher). Its three-year total (2007-2009) of nearly 800 questionable claims is 3.5 times greater than the national average of 224. Roughly half of the staged/caused accidents in the state are found to occur in

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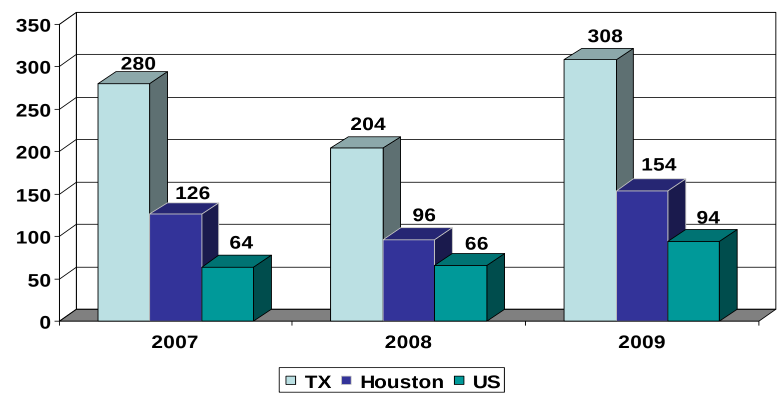
22 *Claims Journal*, "Hailstorms, Heat and Wildfires Made 2011 a Rough Year in Texas," Jan. 30, 2012
23 FBI, "Crime in the US, 2010"

Houston, the 5th top ranking city in the nation (New York City, Tampa, Miami, and Orlando are higher).[24]

Staged accidents usually involve "runners" who recruit "patients" and "jump-ins" (i.e., people who jump into a vehicle after a crash). It is not uncommon for multiple numbers of individuals claiming to be injured. The higher number of "injured jump-ins" may partially account for the higher liability claim frequency compared to the nationwide average.

Staged/Caused Accidents: Questionable Injury Claims
Texas – Fourth Highest State; Houston – Fifth Highest City



Note: The US result is the arithmetic average of the total.

Highest Number of DUI Accidents
According to the Texas Department of Transportation, Texas leads the nation with respect to DUI crashes and fatalities.[25] This state also has one of the highest proportions of drivers (28.3 percent) involved in fatal crashes with a high blood alcohol concentration level greater than or equal to 0.08 (the legal limit of intoxication in the state).[26]

Higher Uninsured Motorist Population
By law, all registered motor vehicles in Texas should be covered by auto liability insurance. Texas' latest U.M. population is determined to be 14.9 percent, slightly higher than the national average of 13.8 percent.[27] This state is now ranked 19th highest in the nation. Exposure to a higher proportion of uninsured motorists contributes to a higher overall insurance premium.

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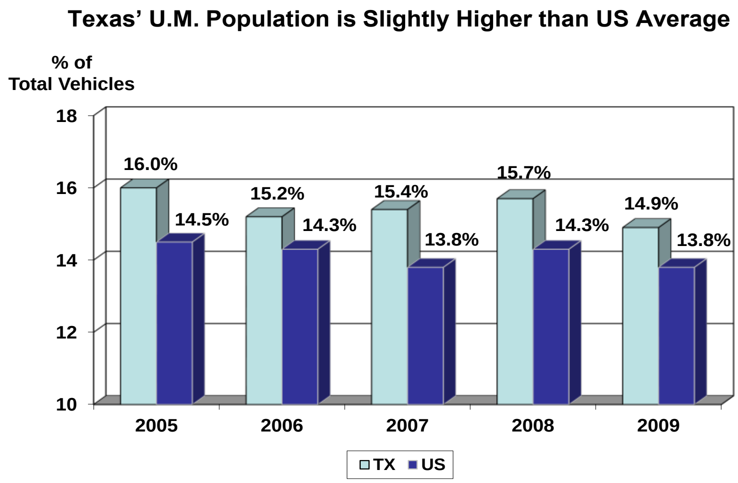
24 National Insurance Crime Bureau, "ForeCAST Report: Staged/Caused Accident Questionable Claims, Bodily Injury and Personal Injury Protection Claims 2007 – 2009," May 6, 2010
25 www.texasdwi.org
26 *Traffic Safety Facts*, 2009; US Department of Transportation, National Highway Traffic Safety Administration
27 Insurance Research Council, *Uninsured Motorists, 2011 Edition*



Urban Traffic Congestion in Texas
No doubt, Texas has some of the most highly – and densely – populated cities in the nation. Houston and Dallas and their surrounding suburbs make up extremely crowded, sprawling metropolises. One of the negative consequences of high population density is severe traffic congestion – measuring the number of hours delayed per auto commuter, Houston and Dallas-Fort Worth-Arlington rank 4th and 6th highest among very large urban areas in the US.[28] The very large concentration of motor vehicles results in a high probability of being in an auto accident which has an impact on insurance claims.

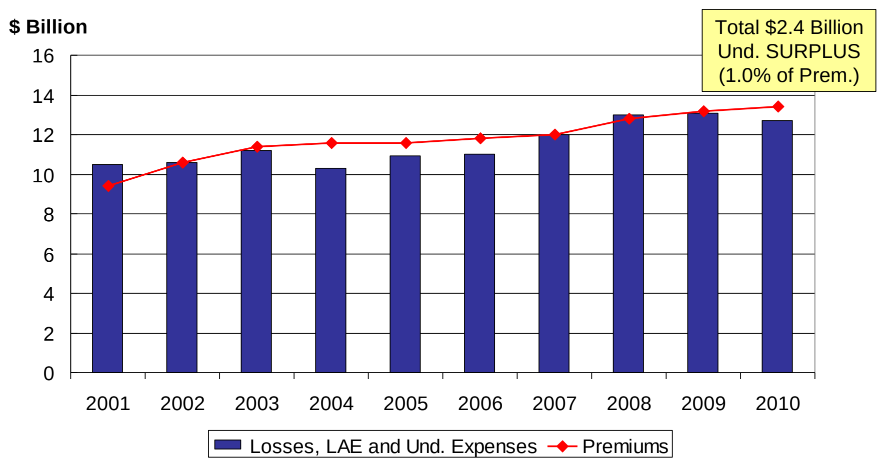
Higher Number of Luxury Vehicles
According to a study by Experian Automotive,[29] Texas ranks 8th highest in the nation with respect to luxury vehicles sold. Among the 680,000 new cars sold in the state in 2009, 6.5 percent were luxury brands made up primarily of Lexus, Mercedes Benz and Maseratis. Higher numbers of expensive cars mean more expensive collision repairs when they are damaged from crashes – which likely happen often in dense urban traffic. Luxury vehicles are yet another factor contributing to Texas' higher-than-average collision claim costs and, hence, higher-than-average collision premiums.

Texas Auto Premiums are Adequate; Profits are Not Excessive
One economic theory of a perfectly competitive model is that there are no long-term excessive profits. In general, insurance prices should not exceed the associated costs of the product or service by more than a normal profit margin when viewed over a reasonable time period.

[28] University Transportation Center for Mobility, Texas Transportation Institute, "Real-Timing the 2010 Urban Mobility Report," Feb. 2011 (the top 3 highly congested, large urban areas are Chicago, Washington DC, and Los Angeles-Long Beach-Santa Ana)
[29] Forbes.com, "States with the Most Expensive Cars," Nov. 6, 2009

From 2001 to 2010, Texas auto insurance premiums collected by insurers totaled $117.7 billion, while related losses, loss adjustment expenses and underwriting expenses totaled $115.3 billion. This has resulted in an underwriting surplus of $2.4 billion, or a nominal underwriting profit of 1.0 percent of premiums. Investment income helped increase the operating return to 2.6 percent.[30]

Texas Auto Ins. Premiums are Sufficient To Cover Losses and Expenses



Texas' returns are very much in line with national average underwriting and operating profits of 0.3 percent and 3.3 percent of premiums, respectively.[31] The profits made by Texas auto insurers have by no means been excessive.

The Texas Auto Market is Healthy and Competitively Structured

The Texas auto insurance market is stable, as denoted by its normal underwriting and operating results. This is further supported by three other factors used to measure competition: (1) ease of entry and exit of firms; (2) number of participating firms; and (3) the relative market power of participating firms. Strong competition in this state's auto market helps to exert downward pressure on prices, supplies adequate quantities of desired products and services, and makes alternative sources of supply available to consumers.

Ease of Entry and Exit

In all states, it is not uncommon for insurers to enter and leave particular markets during any time. Ease of market entry and exit is a critically important characteristic of a competitive

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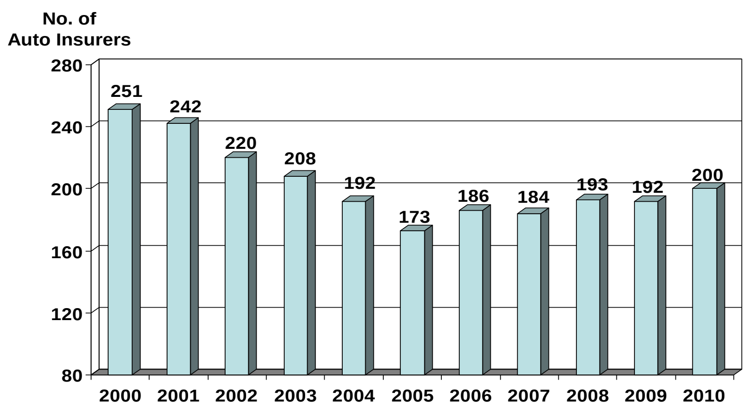
[30] PCI, based on NAIC data from SNL Financial LC
[31] NAIC *Report on Profitability by Line by State, 2011 Edition*

market. So long as entry can be accomplished without substantial difficulty and cost, the market will be influenced by both actual and potential competitors. The costs of entering the Texas insurance market include the relatively minor costs associated with obtaining a license and satisfying capitalization requirements. During the past decade, the total number of insurance companies writing personal auto business here has ranged from about 173 to 251, suggesting that the ability to enter and withdraw is accomplished quite easily.

Number of Competitors

The greater the number of active firms operating in a market, the stronger is the presumption of sufficient competition. Latest data indicate the presence of 200 insurance carriers offering personal auto coverage in Texas.[32] Despite the fluctuation in the number of auto insurers over the past decade, the quantity has remained sufficiently high to indicate a healthy competitive market.

The Texas Auto Insurance Market is Healthy with Sound Competition



Market Power

Theoretically, if one or a few firms control unreasonably large shares of the market, then prices and availability might be unduly influenced by the actions of the leading firms. Based on companies' market share data, the Texas auto insurance market is found to be unconcentrated – in other words, the market is competitively structured, indicating that no single insurance group or small number of insurers controls a large enough portion of the market to influence prices or availability.[33]

[32] NAIC database from SNL Financial LC

[33] Market concentration is measured by the Herfindahl-Hirshman Index, commonly used by the US Department of Justice. Texas' personal auto index value is well below 1,000, indicating a competitive or "unconcentrated" market. Values greater than 1,800 denote "high concentration," while values between 1,000 and 1,800 indicate "moderate concentration." Higher indexes mean less competition.

Suggestions to Improve Availability and Affordability of Coverage

As demonstrated in the preceding sections, Texas' homeowners and auto premiums are high but not excessive. This is especially true in homeowners, given this line's declining rates. Regardless of what the rate levels are, costs can still be contained in both homeowners and auto lines. This section discusses potential solutions to lowering the underlying claim frequency and/or claim severity that influence insurance prices.

Homeowners Insurance

While the frequency and severity of weather events cannot be controlled, it is nonetheless critical to address Texas' vulnerability to catastrophic losses and take positive action towards reducing losses resulting from natural disasters. Loss mitigation should be at the forefront of any property insurance solution as it promotes public safety, minimizes property damage and preserves communities hit by natural disasters. According to one analysis,[34] future hurricane losses could be reduced by as much as one-third if appropriate mitigation steps are taken. By building stronger and incentivizing consumers to harden their residences, more property carriers will also be encouraged to operate in Texas and invest much needed capital here.

Two essential straightforward measures to transform Texas' homeowners market and improve the availability and affordability of insurance are establishing strongly enforced uniform statewide building codes and offering hazard mitigation grants. These initiatives will bring disaster-related costs under control.

Enforce Stronger Building Codes

A building code is the minimum acceptable standard used to regulate the design, construction, and maintenance of buildings for the purpose of protecting the lives and general welfare of consumers from the hazards of unsafe structures and conditions. By increasing construction standards to make buildings more resistant to damage, the frequency and severity of property claims will decrease over time and provide a positive stabilizing effect on costs. Lower amounts of property damage speeds up the recovery process, causes less disruption for property owners and puts less pressure on the insurance marketplace. Studies have shown that for each dollar increase in construction costs, there is a long-term savings of $3 to $16.[35]

[34] University of Pennsylvania, Wharton School presentation at the First International Conference on Asian Catastrophe Insurance, Innovation & Management, "Catastrophe Insurance Challenges for the US and Asia," Dec. 2007

[35] Institute for Business & Home Safety, "Natural Hazard Mitigation Insights," Nov. 2005

In order to be effective, enforcement of a uniform statewide building code with the same standards applying to virtually every type of structure (residential, commercial, industrial, schools, farm buildings, etc.) in all Texas jurisdictions is critical. Enforcement ensures compliance with the building code and is a key factor in saving lives and minimizing the impact of a natural disaster on overall losses and premiums.

Hazard Mitigation Grants

Raising public awareness of catastrophe risks is key to motivating homeowners to become more proactive in reducing their losses. The issuance of hazard mitigation grants has demonstrated high benefit-to-cost ratios. On average, a dollar spent by the US Treasury on Federal Emergency Management Agency mitigation grants provides about $3.65 in savings, translating into reduced post-disaster relief costs.[36]

Other solutions to lowering homeowners costs include adopting property fraud-related legislation.

Contractor Fraud

After severe weather events, crooked contractors typically descend upon neighborhoods in an attempt to take advantage of unsuspecting homeowners. Texans are especially vulnerable to these unscrupulous individuals given the number of large storms that take place here. While the vast majority of contractors are honest and reputable, more states across the country are taking positive steps to crack down on crooked contractors, particularly those from out of state, who use questionable solicitation and business tactics.

Protecting consumers from contractor fraud and abuse should be a priority. Texas lawmakers should advance much needed legislation that will help protect homeowners from contractor fraud and abuse. Effective legislation would go a long way in preventing homeowners from being victimized in the future.

Other Homeowners Insurance Fraud

Another type of homeowners fraud typically takes place when someone knowingly submits an inflated claim on their insurance policy for more than the actual value of the loss or damage. Examples of this type of crime include staging a phony burglary and falsifying a theft or property damage; overstating the value of stolen items or lying about the extent of damage; intentionally damaging property to make a claim; asking a repairman to increase an estimate or bill; and fabricating repair bills, receipts or other supporting evidence, often in collusion with a crooked contractor, plumber, repairman or insurance adjuster.

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[36] Multihazard Mitigation Council, National Institute of Building Sciences, "Natural Hazard Mitigation Saves: An Independent Study to Assess the Future Savings from Mitigation Activities," 2005

According to the Insurance Information Institute, fraudulent property and casualty claims on homeowners insurance policies cost insurers nationwide about $30 billion annually. Fraud hurts everyone since the increased insurance losses are ultimately passed on to policyholders in the form of higher premiums.

Texas lawmakers can make a positive difference in combating property fraud. Legislation can include defining insurance fraud as a specific crime and creating an insurance fraud unit within the insurance department with the power to investigate and punish perpetrators. Insurers should be required to develop thorough plans for preventing and detecting fraud and have warnings on applications and claim forms that fraud is a serious crime. They should be allowed a reasonable amount of time to investigate suspected fraudulent claims before making any payments, and be given immunity when they share fraud-related information with other insurers, investigators and law enforcement.

Auto Insurance

Texas' auto insurance market is competitive, yet premiums are still one of the highest in the US. Instead of focusing on premiums themselves, legislators and regulators should focus their attention on the true underlying costs. As mentioned earlier, Texas has surpassed most states in terms of stolen vehicles, staged/caused and DUI accidents and uninsured motorists. Below are suggestions on how these factors could be improved to keep costs down.

Reduce the Very High Motor Vehicle Theft Rate

One area where Texas could benefit more in terms of reducing its high motor vehicle theft rate is in its participation in the National Motor Vehicle Title Information System; this program is designed to prevent vehicle theft and fraud through an electronic means of verifying and exchanging title, brand (e.g., junk, salvage), and theft. Although the Texas state motor vehicle titling agency provides regular data updates to the NMVTIS, it does not make NMVTIS inquiries before issuing a new title on an out-of-state vehicle and before every title verification regardless of its origin or reason.

Fully participating state titling agencies – which Texas is not – are able to use NMVTIS to prevent fraud by verifying the motor vehicle, title and brand information and information on whether the vehicle has been reported stolen, all prior to the titling jurisdiction's issuing a new title. In essence, data verification allows fully participating states to reduce the issuance of fraudulent titles and reduce odometer fraud. These states can also ensure that brands are not lost when a motor vehicle travels from one state to another.

According to the NMVTIS website and American Association of Motor Vehicle Administrators, there have been positive results for some states fully participating in the program: e.g., Arizona experienced a 99 percent recovery rate on vehicles identified as stolen; Florida cracked a car theft ring responsible for cloning more than 250 cars valued at $8 million; and Virginia saw a 17 percent decrease in motor vehicle thefts.[37]

Reduce the High Number of Staged/Caused Accidents

Insurers should be allowed to investigate suspicious injury claims, such as those resulting from staged/caused accidents. By using normal investigative tools (e.g., second opinion medical exams and questioning those making claims under oath), fraudulent claims can be detected or deterred altogether. Insurers should be afforded the opportunity to defend against claims that are not medically necessary or fraudulent.

There may also be unscrupulous health care providers and/or clinics working with others to abuse the insurance system. Legislation with strong penalties for violations should be passed to require decertification of providers who commit fraud and to stop individuals from acting as or using "runners" to recruit clients. Insurers should be allowed to conduct on-site inspections of clinics to ensure they are legitimate and their services are real.

Reduce the High Number of DUI Accidents

In order to be truly successful in reducing the number of DUI accidents, *all* convicted DUI offenders should be required to have ignition interlock devices fitted in their motor vehicles. These devices are intended to prevent drivers with certain blood-alcohol concentration levels from starting the car. Since this program began in Hawaii, nearly 1,000 motorists have installed these devices and hundreds of car starts have been prevented because BAC levels of .08 percent and above were detected. According to the Hawaii Transportation Department, more than 3,000 cars with drivers having a BAC between .025 and .079 could not start.

Reduce the Uninsured Motorist Rate

Given its higher-than-average uninsured motorist population, Texas' compulsory liability law has not been effective in preventing uninsured drivers from owning or operating a vehicle. State reporting database systems – which are costly and difficult to implement and maintain – are not adequate in identifying and tracking uninsured motorists either.

In lieu of database systems, PCI supports enforcement based on financial responsibility standards and an identification enforcement approach, which target drivers who pose the highest risk to other motorists. "Red flags" could include drivers whose licenses or registrations have been previously suspended or revoked; have been convicted of insurance violations; have multiple traffic law convictions; and have repeated accident involvement. "Problem" drivers should be required to file proof of financial responsibility with the local DMV for one to three years. Online identification programs assisting law

[37] www.nmvtis,gov/nmvtis_states.html and www.nmvtis.gov/nmvtis_consumers.html

enforcement officials and the DMV should help reduce the U.M. population without excessive taxpayer costs, undue public harassment, and unnecessary insurer expenses ultimately paid by policyholders.

Other approaches to incentivize drivers to purchase insurance include:

- a “no pay/no play” system, whereby motorists can lose the right to sue for non-economic (pain and suffering) damages if they are injured in an auto accident.
- adopting mandatory fines on those without coverage; these fines should not be reduced by judges (who often reduce fees based on hard-luck stories).
- Allocate additional funds to local police departments for the monitoring of courthouse parking lots. The intent is to ensure that motorists who have their driver's license revoked or suspended or who are unable to provide evidence of insurance to the judge do not then get right back into their car and drive away.

Modernize the Personal Lines Rate Regulatory System

Texas currently has a file-and-use rating law that in essence acts more like a prior approval law in the sense that “speed to market” is greatly deterred. An inordinate number of forms are required to be completed in the filing process and the TDI often contests rate filings, discouraging insurers from implementing rate adjustments in a timely fashion. Specific insurer concerns with the Texas filing process are provided at the end of Appendix IV.

Texas should join the 39 other states (including the District of Columbia) that currently have a more competitive-based rate regulatory law. Less restrictive, or more market-oriented, rating laws (including flex-rating) rely on competitive forces to ensure that insurance rates are consistent with underlying costs. Insurers can react quickly to changing loss trends and implement rate increases or decreases in a timely fashion, hence keeping the market stable and strong. These types of laws operate to curtail excess profits, improve insurance availability, remove rate regulation from political volatility, and increase regulatory efficiency. Companies are able to accept a broader range of insurance applicants as well.

Benefits resulting from a move to greater rate competition generally include: (i) an increased number of insurers that are more willing to operate under improved conditions; and (ii) the ability for insurers to more accurately price their products, creating cost savings in the form of lower rate increases or even rate decreases. For example, South Carolina converted its homeowners rating law from prior approval to flex-rating in mid-2004. Since 2005, this state has welcomed 27 new or returning insurers, offering greater choices to the public.[38]

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[38] NAIC data from SNL Financial LC

Appendix I

An Overview of Texas Residual Markets

The Texas Windstorm Insurance Association: "Residual Market of Last Resort"

To ensure that residents and businesses have wind and hail coverage, the Texas Windstorm Insurance Association (TWIA) was initially set up as the "insurer of last resort."[39] TWIA is a pool of all the insurance companies authorized to write property coverage in the state; all members share in the association's losses based on their premium writings.[40]

Fourteen "first tier" coastal counties and parts of Harris County are covered by TWIA.[41] By law, minimum limits are set with an automatic annual adjustment to reflect inflation.[42] TWIA's overall rate increases are capped at 10 percent (15 percent for an individual rating class) unless the Texas Department of Insurance (TDI) determines that a higher increase is necessary due to catastrophic events. Overall residential and commercial rates do not need approval if they are within a ±5 percent flex-band (or less than 10 percent flex-band for an individual rating class). Deductible options for residential risks are $100, $250 or 1 percent (unless an optional large deductible is selected).[43]

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[39] TWIA, originally called the Texas Catastrophe Property Insurance Association, was established in 1971 after Hurricane Celia (1970) struck the Gulf coast, causing extensive damage and forcing many insurers to stop writing business in the state's coastal areas. There is also a Texas FAIR Plan for people unable to find fire dwelling and limited homeowners coverage in the voluntary market; the FAIR Plan wrote about 110,600 policies with insured property value of $14.2 billion in 2010 (*PIPSO Reports*, June 2011).

[40] An insurer that becomes a new TWIA member is not subject to participation in insured losses and operating expenses until the second anniversary of the date on which the insurer becomes a member. Source: Powerpoint slides, "TWIA Overview, prepared by the TDI," April 25, 2012 for Quarter ending 03/31/12

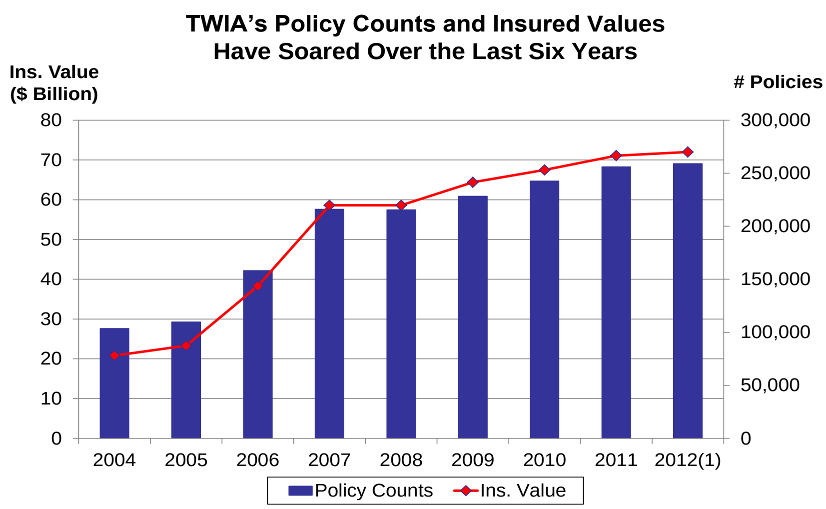
[41] TWIA covers Aransas, Brazoria, Calhoun, Cameron, Chambers, Galveston, Jefferson, Kenedy, Kleberg, Matagorda, Nueces, Refugia, San Patricio, and Willacy, and parts of Harris County including inside Houston's city limits and east of Highway 146: LaPorte, Morgan's Point, Pasadena, Seabrook and Shore Acres.

[42] Effective Jan. 1, 2012, limits for residential property are $1.5 million up to $1,773,000. Coverage for contents of apartments, townhouses and condominiums are $374,000 and for governmental or commercial properties, up to a maximum of $4,424,000.

[43] For commercial risks and public buildings, a per-occurrence deductible of 1 percent per item applies. Unless an optional 2 percent or 5 percent is selected and the deductible percentages are subject to the appropriate premium credits. Source: Powerpoint slides, "TWIA Overview, prepared by the TDI," April 25, 2012 for Quarter ending 03/31/12

Although TWIA was not intended to compete against the private market, it has become the primary windstorm insurer in the Gulf Coast region. As of March 31, 2012, there were 245,754 residential (dwelling and mobile homes) and 13,297 commercial policyholders (totaling roughly 259,100 policyholders) insured with TWIA.[44]

Instead of depopulating its book of business as originally intended, the pool's policy count and loss exposure have expanded at a very rapid pace due to increased coastal development and greatly diminished writings by private insurers. Since 2004, the policy count has grown by more than 2.5 times and the insured property value (or direct liability in force) has more than tripled (almost 3.5 times). The largest growth periods took place in 2006 and 2007, increasing at a robust rate of about 40 percent each year. Both policy counts and insured values continue to grow, but at slower annual increases of about 5 to 6 percent over the last few years.[45]



TWIA has a complex multi-tiered funding structure to pay claims; prior to 2009, losses were first paid by members using premiums. Any unpaid losses would then be funded in the following order: by the Catastrophe Reserve Trust Fund (CRTF),[46] any available reinsurance,[47] non-reimbursable member assessments,[48] and finally tax credits that reduce the state's general revenues fund.

[44] TWIA Quarterly Statistical Report, as of March 31, 2012
[45] TWIA (2011 policy count is estimated by PCI)
[46] The Catastrophe Reserve Trust Fund holds about $148 million as of March 31, 2012.
[47] TWIA may purchase reinsurance to cover excess losses. The current amount of reinsurance available through May 31, 2012 is $636 million in excess of a $1.6 billion retention.
[48] So far, TWIA has assessed its member companies to pay for excess storm losses from four different events: (1) Hurricane Alicia (1983, $157 million, $57 million subject to premium tax credits); (2)

TWIA's funding mechanism has not been viable for a long time due to its rapid expansion and the high cost of very severe storms. With a current direct liability in force of $72.0 billion (for building and contents) and indirect liability in force of $7.1 billion (for additional living expense and total business income),[49] corresponding premiums of just over $400 million are highly inadequate. Indeed, a recent independent actuarial study commissioned by the TWIA Board determined that TWIA rates for residential coverage is inadequate by 47% and commercial rates are inadequate by 35%.

In order to make the wind pool more self-sustaining and avoid further serious market disruptions, the 81st Texas legislature enacted House Bill 4409 on June 19, 2009 which made positive changes to the funding mechanism. Specifically, losses in excess of premiums must first be paid from available reserves and the CTRF, and then through the issuance of post-event public securities in an amount up to $2.5 billion.[50]

HB 4409 also clarified TWIA's role as a "*residual* insurer of last resort" for the Gulf coast territory and not function as a competitor in the private market. TWIA applicants must have proof of at least one declination from a private insurer before being eligible for coverage from TWIA and meet its current building code requirements. The bill also mandated the development of an incentive program to encourage the private market to write along the coast and authorized TWIA to use catastrophe models and rating territories.

Furthermore, in a special session in 2011, House Bill 3 was passed in part (on September 28), providing other beneficial reforms. Significant changes include the ability to issue *pre-event* bonds and limitations regarding the filing of claims (within one year from the date of loss) and lawsuits (within two years of the denial of a claim). Insurers may include these provisions in their homeowners policies as an incentive to write more business in coastal areas.

Additional provisions of HB 3 include:

- disputes over damage amounts for accepted claims are subject to a binding appraisal process;
- claimants must give 60 days' notice of their intent to sue; and

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Hurricane Rita (2005, $100 million); (3) Hurricane Dolly (2008, $100 million); and (4) Hurricane Ike (2008, $430 million, $230 million subject to premium tax credits).

[49] TWIA Quarterly Statistical Report, as of March 31, 2012

[50] Public securities are issued in three classes: (1) Class 1 securities up to $1 billion, repaid by TWIA policy premiums; (2) Class 2 securities up to $1 billion, repaid by 70 percent non-refundable premium surcharges assessed on all coastal property casualty policyholders and 30 percent by non-recoupable member assessments; and (3) Class 3 securities up to $500 million repaid by non-recoupable member assessments.

- TWIA may require mediation or another form of dispute resolution.

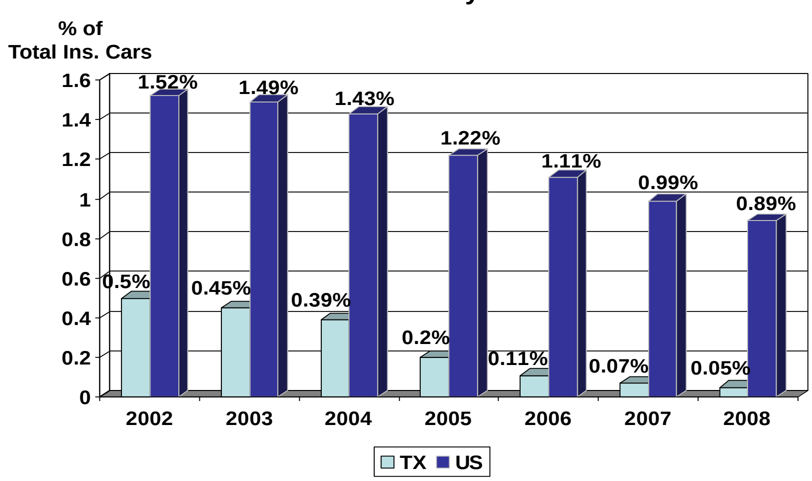
Although TWIA is far from being financially solid, HB 4409 and HB 3 are very positive and important steps towards funding future storm losses and improving the state's insurance market.

The Texas Automobile Insurance Plan Association

Auto insurance applicants who are unable to obtain coverage through the voluntary market – or through county mutuals in Texas – must turn to the involuntary (or residual) market. If a marketplace does not function well, there will be an inordinate number of policyholders in the residual market. This may be due to legislative or regulatory initiatives causing insurers to discontinue writing in certain areas or certain risks, to implement more restrictive underwriting standards, or to artificially depress rates in the residual market.

In Texas, auto residual market rates and policy forms for all risks are assigned by the Texas Automobile Insurance Plan Association (TAIPA).[51] Over the years, the state's auto residual market share has been lower than the national average and, like the norm, has steadily dropped.[52] This downward trend reinforces the fact that insurers are consistently taking policyholders out of the Plan and writing them in the voluntary market. In other words, auto insurance in the primary market is readily available for almost all drivers.

TAIPA's Market Share is Lower than the US Average and Has Steadily Declined



51 TAIPA only offers basic liability, PIP, and uninsured/underinsured motorist coverages.

52 *AIPSO Facts*

Appendix II

Enhancing Consumer Awareness of Rates and Coverages

Since insurance is such a vital part of people's lives, they should have as much information as possible to make knowledgeable decisions about which carrier to select and understand the coverages they have. It is important for all state insurance departments to provide robust and helpful consumer services. In fact, each department does provide publicly available consumer brochures to help people better understand the basics of homeowners and auto insurance (in addition to other lines) and what options are available. Some states also publish rate comparison guides to help people get the best value when they purchase insurance.

In response to the growing use of the Internet to obtain information about insurance products and services, Texas is one state that has capitalized on digital communications. The website, www.helpinsure.com, is a service of the Texas Department of Insurance (TDI) and the Office of Public Insurance Counsel (OPIC) that helps Texans with their auto and residential property insurance needs.

By using this interactive tool, people can access excellent and easy-to-use guides that allow them to compare rates offered by a variety of companies writing auto and homeowners insurance in Texas. Helpinsure.com is especially beneficial since the rate estimates provided reflect the consumer's personal profile which is entered by the user.[53] These guides also provide very thorough information on what companies offer in terms of policy coverages. Even more impressive is the fact that there is an online translator for TDI website publications in Spanish, Chinese, Vietnamese and Korean.[54]

Consumers in other states may be able to find rate comparisons on their insurance departments' website, but it is very unlikely that any of these surpass the TDI's guides in either quality or efficiency.

One possible way in which the TDI could increase consumer awareness of the insurance product is through the power of social media. Social media tools such as Facebook and Twitter have become the primary means of communication in today's' digital world. They are an easy-to-use and multi-dimensional way to interact with others, inform and educate consumers, and send real-time messages online, ultimately forming close, trusted bonds with customers. Having a stronger online presence via Facebook and/or Twitter could attract new

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[53] The rates in the guides are samples. The website states that a consumer's actual premium will be based on his or her individual circumstances and could be higher or lower than the sample rates shown. The consumer should contact the company or an agent directly to get an exact premium quote.

[54] NAIC *2010 Insurance Department Resources Report*

consumers to www.helpinsure.com to access rate and coverage guides, and it could also facilitate Q&A and, if necessary, complaints. Transparency would be increased as well.

Texas State and City offices could also help spread the word to improve consumer awareness of rates and coverages. This could be accomplished by developing communications materials, including news releases, public service announcements, multimedia and educational campaigns. Constituent messages could focus on the benefits of shopping around to find the right and most affordable insurance to meet different individual or household needs.

Appendix III

The Evolution of Texas Policy Forms

The personal lines insurance system in Texas has always been unique – Texas is the only state in the nation with a long history of promulgating its own homeowners and automobile insurance policy forms, exclusions and endorsements for regulated insurers.

Homeowners Insurance

An Overview of Policy Forms Before the 2000 Texas Mold Crisis

Prior to 1991, the Texas Department of Insurance (TDI) (then known as the Texas State Board of Insurance[55]) had developed uniform homeowners insurance policies to be used by all insurers. The types of policies sold in Texas included three TDI-approved standardized forms: HO-A, HO-B and HO-C:

- HO-A policies provided actual cash value coverage of the dwelling and its contents. Only the types of damage listed in the policy are covered (i.e., “Named Perils” coverage).

- HO-B policies provided replacement cost coverage for most types of damage, except those specifically listed in the policy as being excluded (i.e., “All Risk” dwelling coverage). Although the policy covers “all risks,” it excluded certain perils such as mold, specifically stating: " We do not cover loss caused by: rust, rot, mold, or other fungi." In the case of water damage, this coverage was more generous than comparable policies available in the rest of the country.[56]

- HO-C policies provided “all risk” coverage for the dwelling *and contents*.

In 1991, the use of homeowners policy forms could be adopted by a national organization of insurance companies if they were approved by the TDI. Coverage must be “equivalent” to the coverage provided under the prescribed policy forms. Insurance companies could file

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[55] In 1991 the legislature changed the agency’s name from the Texas State Board of Insurance to the Department of Insurance.

[56] The HO-B policy form covers water damage from continuous or repeated leakage from plumbing, heating, air conditioning, and covers damage from backup of sewers/drains, whereas in the rest of the country this coverage must be purchased by separate endorsement on the comparable Insurance Services Office (ISO) HO-3 policy; source: Legacy Texas Insurance Comparison Chart http://www.legacytexasinsurance.com/personal/home-and-auto-comparison-chart

endorsements that enhanced or added coverage to prescribed forms – endorsements also needed to be approved by the Board.[57]

Subsequent legislation was passed in 1997 allowing national insurance companies to develop their own policy forms, offering various levels of coverage. The law was more flexible, whereby the "equivalent" coverage requirement was removed; insurance companies were permitted to file for approved endorsements that could either enhance or restrict coverage provided in the prescribed policy forms.

Homeowners Policy Forms Continue to Evolve from the Texas Mold Crisis

In early 2000, 90 percent of Texas homeowners policyholders had the HO-B form.[58] It was also during this time when mold emerged as a very critical problem, particularly along the coast. While HO-B specifically excluded losses caused by mold, court interpretation of contract language regarding ensuing losses from water damage required that certain unintended mold-related losses be paid. One particular court case (2001) with a $32 million judgment brought great attention to mold-related damage and remediation; an outcome from this well-publicized case was an onslaught of mold claims.[59] As mentioned earlier, mold claims were the number one cause of loss in the state, representing 51 percent of homeowners premiums in 2002. Average mold losses rose as high as $100,000 per claim.[60]

The very large number of mold claims led to a serious disruption to the homeowners market. More insurers began moving away from the broad water damage and mold remediation coverage and stopped offering the HO-B policy; instead, they migrated more towards the HO-A "named perils" policy. Other insurers implemented large rate hikes between 2000 and 2002 in anticipation of continued future mold losses (along with the increase in weather-related risks; most rates were also unregulated).

In an effort to stabilize the homeowners market, the TDI eliminated coverage for mold testing and remediation from the HO-A, HO-B, and HO-C policies.[61] Since mold testing and remediation had been removed from the forms, premiums were adjusted accordingly to reflect this change. Contrary to what some have alleged, *consumers are not "paying more for less coverage."* With respect to the resulting decreases in coverage, the TDI reported, "the effect of the coverage reduction has brought the claims cost for the water peril back to levels closer to the historical norm before the mold crisis when mold testing and remediation

[57] Texas Department of Insurance, "Texas Homeowners Insurance Policy Comparison, Jan. 2011; "www.tdi.texas.gov/reports/documents/82hopolicycomparison.pdf
[58] Ibid.
[59] *Ballard v. Fire Insurance Exchange*, Texas 2001
[60] Texas Public Policy Foundation, "Legislators' Guide to the Issues," 2007-2008
[61] Mold coverage was allowed as an optional buy-back for a premium, effective Jan. 1, 2002.

significantly increased the cost of water damage claims" and "(a)s a result of these changes, overall rates declined by 13.5 percent."[62]

After 2003, the mold crisis had largely quieted down, which in turn reduced the number of related lawsuits in this area.

2002 Policy Forms and Beyond

In 2002, the TDI approved the first homeowners policy forms filed by several large national insurers and the Insurance Services Office, Inc. During the following year, comprehensive Senate Bill 14 was passed,[63] which among other items, enabled all insurers and advisory organizations to file for approval their own homeowners policy forms and endorsements with no minimum coverage requirement. However, insurers could still use the forms that were promulgated, approved or adopted prior to June 11, 2003.

Automobile Insurance

For decades, the Texas State Board was also empowered to promulgate insurance policy forms, exclusions and endorsements for the personal automobile line of business. Auto insurers were required to use standard Board-developed forms, which were strictly regulated, in all policy transactions. Although a process did exist to modify policy forms, it involved a continuous progression of meetings involving an appointed advisory association and Board staff by means of a hearing. This unwieldy process of getting Board approval for providing innovative products was a major impediment to companies that wanted to develop their own forms to respond to individual consumer or market needs.[64]

Similar to homeowners policy changes, auto policy forms filed by a national organization of insurance companies or advisory organization could be used beginning in 1991, as long as they were approved by the TDI. Again, coverage needed to be "equivalent" to the coverage provided under the prescribed policy forms.

Effective June 11, 2003, Senate Bill 14 also changed the way auto insurance policy forms were regulated in the state. Insurers were allowed to use their own auto policy forms which – like homeowners forms – still required approval by the TDI. If they wished, companies may

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[62] Texas Department of Insurance, "Texas Homeowners Insurance Policy Comparison," Jan. 2011; data reflect 2009

[63] Act approved June 11, 2003, 78th Legislative Session, R.S., S.B. 14, 2003 Tex. Sess. Law Serv. Ch. 206

[64] "Report of the Texas Advisory Committee on Rate and Form Regulation of Automobile Insurance," Nov. 1990

continue using the same forms previously approved by the department. Minimum coverage standards no longer applied.[65]

Greater Competition on Policy Forms Benefits Consumers

There are some who believe that different homeowners and auto policy forms complicate and confuse the comparison process when shopping for insurance. They claim that consumers might have trouble finding and choosing the coverages that best meet their insurance needs. It is true that differences among individual company insurance policies exist, but these differences are no more complicated (in fact, they are likely simpler) than other types of financial-related choices consumers make with respect to obtaining mortgages, lease contracts, credit cards and other types of loan agreements, etc. Besides, insurance agents are there to help explain and clarify coverages, exclusions and endorsements and help applicants make their insurance-buying decisions.

Perhaps proponents of uniform policy forms do not realize that Texas' unique system had hurt consumers in several important ways. First, without the ability of companies to provide their own policy forms, consumers had no real choice. In this regard, Texans did not enjoy a superiority of coverage compared to insured homeowners and vehicle owners in other states. Secondly, the use of mandated policy forms in Texas made the provision of coverage significantly expensive relative to other states. This expense was passed along from the insurer to the policyholder in the form of higher premiums.

Board-promulgated forms eliminated an important element of competition within the industry to better serve the market. Since insurers were not permitted to establish their own policy forms, they were unable to take a more aggressive underwriting stance and they were unable to innovate. Company withdrawals in the personal lines market in Texas during the first part of last decade likely stemmed from increased dissatisfaction with the inability to offer consumers innovative products and to compete with one another.

Form flexibility attracts more companies to do business in Texas, as evidenced by the large increase in carriers circa 2004-2005. More companies help to strengthen competition in the state, which ultimately benefits consumers by giving them more choices, greater availability of coverage and lower costs.

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[65] Texas Department of Insurance, *Senate Bill 14 Frequently Asked Questions;* "Personal automobile policy forms and endorsements are regulated under Article 5.145, governed by the provisions of Section 8, Article 5.13-2. Among other provisions, policy forms and endorsements may not contain provisions or titles/headings which are unjust, encourage misrepresentation, are deceptive, or violate public policy."

Appendix IV

Texas Personal Lines Rate Regulation: The Last 25 Years

Pre-1991

Similar to policy form regulation, Texas' personal lines rates were tightly controlled by the State Board of Insurance for many years. As stated in Article 5.01 of the Texas Insurance Code, the State Board had "sole and exclusive power and authority, and it shall be the duty to determine, affix, prescribe and promulgate just, reasonable and adequate rates of premiums to be charged and collected by all insurers…" Insurers were allowed to file for approval upward or downward deviations from promulgated rates, in which case the majority of filings called for deviations. However, every time the Board adjusted its rates, insurers had to re-file their deviations which created a tremendous backlog of filings and a large burden on Board personnel who had to review and decide on the filings.

Making matters worse was the fact that prior approval rate regulation applied to the large majority of insurers, while other groups – e.g., county and farm mutuals and Lloyds companies[66] – did not have their rates regulated at all. As a result of this dual regulatory system, several large companies notified the Board of their plans to withdraw from the market or curtail their writings in 1990. This was critical in light of the shortage of smaller, regional carriers in Texas, creating an availability problem that harmed consumers.

1991 Omnibus Insurance Regulation Bill

In 1991, the 72nd Legislature passed the Omnibus Insurance Regulation Bill which established a flex-rating system, allowing a ±30 percent flex-band in personal lines insurance. Under this approach, the Board set a "benchmark" rate and individual companies were allowed to file and use rate changes that fell within ±30 percent of the rate, effective immediately. Any changes that exceeded the band required regulatory approval.

A loophole in the 1991 law allowed Lloyds companies, county and farm mutuals, and reciprocal and interinsurance exchanges to remain exempt from rate regulation and the benchmark rate system. This led to a movement by some national, regulated companies to establish unregulated entities to insure their customers. Consequently, both the homeowners and auto insurance markets increased in terms of the number of policies written at non-regulated rates.

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[66] Certain exemptions from rate regulation were established by the Texas Legislature in 1921 in an effort to make insurance available to rural homeowners without access to city plumbing and fire protection.

To provide some perspective, Lloyds companies which historically covered high-risk business comprised only 20 percent of the homeowners market in 1991.[67] However by 2001, the TDI estimated that about 95 percent of the Texas homeowners insurance policies were written by non-rate-regulated entities.[68]

2003 – A Landmark Year

A comprehensive insurance bill (SB14, effective June 11, 2003) passed during the 78th Legislative Session in Texas. Designed to bring stability to the market and address availability and affordability problems, SB 14 significantly altered the personal lines rate regulatory environment. Several of the major rate-related changes included the following:

- The flex-rating system was replaced by a file-and-use system. Under file-and-use, rates may be used immediately as long as they are filed with the insurance department no later than the proposed effective date; rates do not require regulatory approval.[69]

- After December 1, 2004, the Insurance Commissioner may order a company's rates to be subject to prior approval if its rating practices or financial condition required supervision, or if a statewide insurance emergency exists.

- More than 30 of the top groups (representing 95 percent of the market) were ordered to reduce their rates by an average of 12 percent.

- The so-called "Lloyds loophole" was closed so that previously unregulated insurance companies were now subject to file-and-use rate regulation. There is no more exemption for Lloyds companies, reciprocal exchanges, etc.

- Rates could not be unreasonable, excessive, inadequate or unfairly discriminatory for the risks to which they applied.

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[67] Texas House of Representatives, House Research Organization, "Focus Report: Regulating Homeowners Insurance in Texas," Oct. 18, 2010; www.capitol.state.tx.us/hrofr/interim/int77-1.pdf

[68] Texas House of Representatives, House Research Organization, "Focus Report: Regulating Homeowners Insurance in Texas," Oct. 18, 2010; www.hro.house.state.tx.us/pdf/focus/HOI81-14.pdf

[69] From June 2003 through Dec. 2004, certain insurers' rate filings were subject to prior approval (with a 30-day deemer period) if their financial condition or rating practices required supervision, or if the TDI wanted to review their data to determine appropriate rate rollbacks. However, small and new insurers were allowed to operate under file-and-use if they did not change their rates significantly.

According to the TDI, regulatory actions arising from SB 14 resulted in policyholder cost savings of $510 million.

The Present Environment

Although Texas' rate regulatory law is file-and-use, the filing process has been unpredictable causing insurers to express great concern over it. Over the last decade, PCI conducted periodic surveys of its members asking for their observations on positive and negative rate and form filing practices of individual state insurance departments. According to participants, the most frequently mentioned negative practice exhibited by the TDI pertains to the number of forms that must be completed. Remarks made in a 2006 survey include the following:

- "There are too many forms to complete for rate filings and some of them are very hard to understand and complete."
- "Several layers of authority within the department for sign-off must be obtained before filings can be approved."
- "Excessive number of forms required for rate filings."
- "Form filing approval needs to be faster. It would be helpful for them to offer more filings through SERFF. It would be helpful to have uniform NAIC forms."

Furthermore, many rate filings have been contested by the TDI, making insurers unwilling to use rates immediately. Other remarks made by insurers are as follows:

- "Insurers are subject to dual regulatory review from the TDI and OPIC. This is cumbersome, inefficient and adds much more uncertainty in the filing process because you have to satisfy two independent parties."
- "File-and-use submissions are often not acknowledged as approved or filed, even after Departmental questions have been received and responded to."
- "Texas does not allow for automatic adoption of advisory organization loss costs and justification for the use of such loss costs."
- "Frustrating that they do not send approval letters, but can later question the filing "

Delays in implementing rates and unexpected administrative costs to justify companies' rates to the insurance department have stifled competitive benefits normally found in other states that have file-and-use rating laws. Modernizing the rating law in Texas would offer consumers more choices, lower rates, greater flexibility, and ultimately the opportunity to find the best insurance for their needs, as well as encourage more insurers to operate here and provide greater consumer protection.

