

No. 07-1040

Official Order  
of the  
Commissioner of Insurance  
of the  
State of Texas  
Austin, Texas

Date: NOV 15 2007

Subject Considered:

Texas Windstorm Insurance Association  
2007 Manual Rate Filing for All Types and Classes of Risks

Docket No. 2670

General remarks and official action taken:

On this day came on for consideration by the Commissioner of Insurance (Commissioner) the matter of the 2007 manual rate filing submitted by the Texas Windstorm Insurance Association (Association) to the Texas Department of Insurance (Department) pursuant to the Insurance Code §2210.352. On August 13, 2007, in accordance with the Insurance Code §2210.352(a), the Association filed with the Department a proposed manual rate (Ref. No. P-0807-06) for all types and classes of risks written by the Association. In accordance with the Insurance Code §2210.352(e), the Department filed a notice with the Secretary of State advising that a manual rate filing under the Insurance Code §2210.352(a) had been made. The notice was published in the *Texas Register* on August 24, 2007, and included information relating to the availability of the manual rate filing for public inspection, the procedures for making written comments relating to the manual rate filing, and the time, place, and date of an open meeting at which interested persons could present written or oral comments relating to the manual rate filing.

On September 18, 2007, an open meeting was convened before the Commissioner in Room 100 of the William P. Hobby, Jr. State Office Building to consider the Association's manual rate filing for all types and classes of risks. All interested persons were allowed to present written and oral comments. Comments were presented by Mike Jackson, state senator for District 11; Jim Oliver and Jim Murphy, representing the Association; Jay Thompson, on behalf of the Insurance Council of Texas (ICT) and the Association of Fire and Casualty Companies in Texas (AFACT); Lee Otis Zapp, Jr., Steve Alexander, and Henry Freudenburg, on behalf of the Galveston Windstorm Action

Committee (GWAC); Rod Bordelon and Ken Lovoy of the Office of Public Insurance Council (OPIC); Joe Woods, on behalf of the Property and Casualty Insurance Association of America (PCIA); Jim Wade, consumer board member of the Association; and Beamon Floyd, on behalf of the Texas Coalition for Affordable Insurance Solutions (TCAIS) member companies and the American Insurance Association (AIA).

After considering the Association's manual rate filing, the rate analyses of OPIC and GWAC, Department staff's analysis, and all written and oral comments presented, the Commissioner adopts the following findings of fact and conclusions of law.

### FINDINGS OF FACT

1. In the Association's proposed manual rate filing for all classes and risks written by the Association submitted to the Department on August 13, 2007, the Association's board of directors recommended a 10 percent increase, the statutory maximum, for both residential and commercial rates based on the Association's actuarial review which produced indications of an 18 percent increase for residential property rates and a 22 percent increase for commercial property rates.
2. OPIC recommended no change for both residential and commercial property rates.
3. GWAC recommended no change for both residential and commercial property rates.
4. The Association, OPIC, and GWAC did not recommend any changes in the classification relativities for the residential and commercial property rates.
5. The Association's proposed rates are based on four components: non-hurricane losses and loss adjustment expenses (LAE); hurricane losses and LAE; expenses other than LAE; and contributions to the Catastrophe Reserve Trust Fund (CRTF).

### Non-hurricane Losses and LAE

6. Both the Association and OPIC used the most recent available statutorily required data to project the non-hurricane losses and LAE component of the rates.
7. The non-hurricane loss and LAE provision recommended by GWAC used a 43-year experience period for residential property risks and a 10-year experience

period for commercial property risks, although the footnote of its exhibit suggests that GWAC had intended to use a 37.3-year experience period to calculate the provision for commercial property risks.

8. The Insurance Code §2210.356(c) and (d) requires that the noncatastrophe element of noncommercial and commercial rates be developed using the most recent 10 years of experience available.
9. The Association and OPIC projected ultimate losses by selecting paid loss development factors from various arithmetic averages of the loss development indications of prior years, including averages spanning up to nine years.
10. In the case of the commercial experience, due to the small amount of paid losses, the loss development factors show a great deal of volatility from year to year, particularly in the 12 to 24 months development interval.
11. The more recent loss development patterns are likely to be more indicative of development patterns that can be expected in the immediate future.
12. The widely accepted averaging methodology called the "Olympic Method," wherein the highest and the lowest loss development factors in the most recent five years are rejected and the average is based on the middle three values utilizes relatively recent experience and tempers the impact of unusually high or low loss development factors. Using this approach is reasonable.
13. The Association calculated and OPIC accepted loss ratio trend factors, also called net trend factors, by dividing the average loss trends for each year by the corresponding premium trends.
14. The Association derived the historical premium trends from the ratio of the average premium of the most recent experience year to that of each individual historical experience year and judgmentally selected a prospective trend from a series of curves representing average historical changes. The Association derived the loss trends from the ratio of the weighted average of coastal construction cost indices and modified consumer price indices of the most recent experience year to that of each individual historical experience year and judgmentally selected a prospective trend from a series of curves representing average historical changes.
15. The resulting annual loss ratio trends of the Association for residential property risks range from -1.3 percent to -3.3 percent, depending on the specific year.
16. The resulting annual loss ratio trends of the Association for commercial property risks show more variation, ranging from +2.2 percent to -4.5 percent, with an average of -1.6 percent.

17. The windstorm coverage rating system is risk based and inflation sensitive.
18. Inflation in building and contents costs are expected to affect both the amounts of insurance purchased, and thus premiums, and the loss cost levels to the same degree. Changes in coverage purchased at the individual policy level, as for example in the deductibles selected, will likewise affect both premiums and loss in similar ways.
19. The trending approach used by the Association and accepted by OPIC treats changes in premiums and loss costs as entirely separate factors with no attempt to reconcile the movements of the two. This can and does lead to anomalous results.
20. Under the rating plan used by the Association, premiums and loss cost levels are expected to change at the same rate. Changes in premium and lost cost levels would normally be assumed to offset each other, producing a zero net trend.
21. However, the experience described in Finding Nos. 15 and 16 appears to indicate that the premiums have been increasing at a more rapid rate than loss costs, perhaps due to a movement towards the purchase of limits of coverage more reflective of replacement cost values. This produces a negative net trend.
22. Using a net annual trend of -1.0 percent is reasonable.
23. The Association calculated and OPIC accepted a factor of 1.256 to include non-hurricane LAE based on the experience for non-hurricane years in the 31-year period from 1976 through 2006.
24. Applying a factor of 1.256, as recommended by the Association and accepted by OPIC, to non-hurricane losses in order to include LAE is reasonable.
25. The Association and OPIC differed in their recommendations for the calculation of the average non-hurricane loss ratios in that the Association used a premium-weighted average while OPIC suggested that the same averaging technique be used for computing both non-hurricane and hurricane loss ratios. The Association used an arithmetic average in the latter case.
26. After adjustment for the revised loss development factors (Finding No. 12) and a net annual trend of -1.0 percent (Finding No. 22), the average loss and LAE ratios are 0.123 for residential property risks and 0.114 for commercial property risks using a premium-weighted average and 0.141 for residential property risks and 0.125 for commercial property risks using an arithmetic average.

27. Either averaging approach described in Finding Nos. 25-26 would normally be reasonable to project non-hurricane losses and LAE, but given the large growth in the Association in recent years, the weighted average may give undue weight to the most recent experience.
28. An arithmetic average is a reasonable approach under the circumstances.
29. Based on Finding Nos. 6-28, non-hurricane loss and LAE ratios of 0.141 and 0.125 are reasonable for calculating residential and commercial property rates, respectively, and should be used to calculate the Association's rates.

### **Hurricane Losses and LAE**

30. The Association utilized two different estimates to project the provision for hurricane losses and LAE. It used a historical analysis adjusted to the actual 156-year historical hurricane frequency level and the average of projections from two computer models.
31. OPIC produced three different estimates based on historical experience, which differed in the final storm frequency assumptions.
32. GWAC projected its provision for hurricane losses and LAE by utilizing the Association's residential and commercial property risk data without adjustment for longer-term hurricane frequencies, but removing hurricane losses and LAE ultimately funded by assessments against members of the Association.
33. The Association and OPIC calculated their hurricane loss ratios by taking the loss ratios for years in which there were hurricanes, subtracting the estimated contribution of non-hurricane events to the overall losses in those years, and adjusting the result to reflect their frequency assumption.
34. The Association estimated that the hurricane LAE factor is 1.119 based on the historical experience in years in which hurricanes occurred. OPIC accepted the LAE factor of 1.119. GWAC left the LAE factor out of its calculation.
35. The LAE factor of 1.119 was derived by the Association by dividing the projected ultimate LAE by the total projected losses for each hurricane year and averaging the results.
36. The total projected losses in the hurricane years include losses from both non-hurricane and hurricane events.
37. The overall LAE factor based on the total hurricane year experience is therefore a weighted average of the LAE factor needed to settle the non-hurricane losses

- in those years and the LAE factor needed to settle the losses arising from the hurricanes themselves.
38. Based on Finding No. 24, the LAE factor for non-hurricane events is 1.256. This should be reflected in calculating the LAE factor to be applied to pure hurricane losses. Making this adjustment produces a pure hurricane LAE factor of 1.101 rather than the 1.119 proposed by the Association and accepted by OPIC.
  39. Using the corrected LAE factor of 1.101 is reasonable.
  40. The current funding mechanism of the Association provides that, in the event of an occurrence or series of occurrences that exhaust the current resources of the Association, the excess losses and expenses are paid in the following order: (a) 100 million dollars is covered by an assessment of its members; (b) approximately 400 million dollars is covered by the CRTF; (c) one billion dollars is covered by reinsurance; (d) 200 million dollars is covered by an assessment of its members; and (e) any remaining balance is covered by an unlimited assessment of its members, which is reimbursable from premium tax credits.
  41. The projected hurricane loss ratios calculated by the Association and OPIC reflect amounts that will ultimately be paid from assessments of the members of the Association. Those portions of hurricane loss and LAE are not payable by, nor are they the fiscal responsibility of, the Association and its policyholders.
  42. Excluding the amounts that will ultimately be paid by assessments of the members of the Association from the projected hurricane loss and LAE ratio, as recommended by GWAC, is reasonable since the Association and its policyholders are not liable for the amounts involved.
  43. The Association's funding mechanism for hurricane losses and LAE does not differentiate between residential and commercial property risks. Therefore, the combined historical experience of residential and commercial property risks should be used in order to calculate the net hurricane loss and LAE excluding the assessments.
  44. The Association provided the most recent 37.3-year (1970-2006) historical experience for commercial property risks while OPIC provided the most recent 41-year (1966-2006) historical experience. Both provided the most recent 43-year (1964-2006) historical experience for residential property risks.
  45. Since 1964 and 1965 were non-hurricane years, using them in addition to the 41-year (1966-2006) experience provided by OPIC for commercial property risks effectively produces a 43-year (1964-2006) experience period to project the hurricane loss and LAE ratio for commercial property risks as well.

46. Using the combined 43-year historical experience for residential and commercial property risks to project the hurricane loss and LAE ratio is reasonable.
47. The Association proposed to adjust the projected hurricane loss ratio based on historical data to reflect the actual 156-year hurricane frequency as compared to the hurricane frequency of the 43-year period for residential risks and 37.3-year period for commercial property risks.
48. OPIC provides projections for residential property risks based on three different storm frequency assumptions: the actual 43-year hurricane frequency; the average of the 107-year and 43-year hurricane frequencies; and the average of the 156-year and 43-year hurricane frequencies. The projections for commercial property risks were similar, except that only 41 years of experience were used for the base projections.
49. GWAC proposed to use the actual 43-year hurricane frequency for residential property risks and 37.3-year hurricane frequency for commercial property risks, with no adjustment for the longer term frequencies.
50. The hurricane frequency in the most recent 43/41-year period was less than that in either of the longer-term periods.
51. It is not clear whether the 156-year, 107 year, or the more recent 43/41-year hurricane frequency history best predicts the hurricane activity in Texas in the immediate future.
52. Giving some weight to the longer-term hurricane frequencies by adjusting the hurricane loss ratio and LAE ratio to reflect the average of the 156-year hurricane frequency and the 43-year hurricane frequency is reasonable.
53. Based on Finding Nos. 30-52, the combined average hurricane loss and LAE ratio is 35.4 percent before adjusting for amounts that will ultimately be paid from member assessments.
54. Adjusting the combined average hurricane loss and LAE ratio for amounts which will be ultimately paid from member assessments reduces the hurricane loss and LAE ratio to 22.3 percent.
55. The hurricane loss and LAE ratio described in Finding No. 54 is reasonable and should be used to calculate the Association's residential and commercial property rates.

**Expenses Other than LAE**

56. The Association proposed, and OPIC and GWAC accepted, the following expense provisions: 16.0 percent for commission and brokerage expenses; 4.2 percent for general expenses; and 1.8 percent for taxes, licenses, and fees.
57. The Association, OPIC, and GWAC considered general expenses to be fixed independent of rate changes (fixed expenses). Commission and brokerage expenses and taxes, licenses, and fees were considered to be expenses that vary directly with changes in premium due to rate changes and other factors (variable expenses).
58. The provision for general expenses described in Finding No. 56 was calculated by dividing dollars of historical general expenses by actual written premiums, unadjusted for the rate changes that have occurred in the interim.
59. Because the dollars of general expenses are independent of the rate changes that have occurred in recent years, it is more accurate to estimate the provision for general expenses by dividing the dollars of general expenses by written premiums at the current rate level. This produces a general expenses provision of 3.8 percent.
60. Using expense provisions of 16.0 percent for commission and brokerage expenses and 1.8 percent for taxes, licenses, and fees, both as variable expenses; and 3.8 percent for general expenses, as fixed expenses, is reasonable.
61. The Association purchased reinsurance protection for the 2007-2008 fiscal year to cover one billion dollars of catastrophe claims and LAE in excess of 500 million dollars.
62. The Association proposed a fixed expense provision of 22.9 percent for the net cost of reinsurance, which reflects the excess of the gross reinsurance premiums over the expected average loss and LAE recoveries. The expected recoveries used in the Association's calculations were based on modeled hurricane losses.
63. OPIC recommended a fixed provision of 21.1 percent to cover the net cost of reinsurance based on a hybrid methodology that utilized an average of the historic industry-wide loss ratio results of reinsurers and Texas-specific modeled and historical loss indications.
64. The historic industry-wide loss ratio results of reinsurers cannot be assumed with any degree of certainty to be meaningful indicators of the net cost of the current



- Texas-specific reinsurance contracts purchased by the Association, nor of the current pricing philosophy of reinsurers.
65. GWAC recommended that no reinsurance be purchased in the future; thus, in its analysis, a provision for the net cost of reinsurance is not provided and is unnecessary.
  66. Because the projected hurricane loss and LAE ratio described in Finding No. 55 is based on historical experience, it is logically consistent to use the historical experience instead of the results of a computer simulation model to estimate the net cost of reinsurance.
  67. The gross reinsurance premium used in the Association's analysis is an estimate by the reinsurers based on a projection of the Association's in-force exposure as of October 31, 2007. The actual reinsurance premium charged by the reinsurers will be calculated at a later time based on the Association's actual total in-force exposure as of October 31, 2007.
  68. The Association projected the hurricane losses and LAE covered by the reinsurance contracts to December 1, 2007, the mid-point of the reinsurance contract period for its calculation of the net cost of reinsurance.
  69. Because the hurricane losses and LAE rarely occur outside the hurricane season, which is from June 1 to November 30, losses and LAE should be projected to the middle of the hurricane season (September 1) for estimation of the net cost of reinsurance.
  70. However, dollars used to pay the net cost of reinsurance will be recovered in 2008 under the new rates, when the Association's total premiums will grow further. The premium base used to estimate the provision for the net cost of reinsurance should be projected for the further growth into 2008.
  71. Based on the historical hurricane loss experience in Texas and the Association's current reinsurance contracts, the estimated net cost of reinsurance is 21.7 percent after adjusting to the average of the 43-year and 156-year hurricane frequencies, projecting hurricane losses and LAE to September 1, 2007, and projecting the Association's annual total premiums to 2008.
  72. Using a fixed expense provision of 21.7 percent for the net cost of reinsurance is reasonable.

**Contribution to the CRTF and Long-Term Financial Outlook of the Association**

73. The Association included a 15.0 percent variable expense provision for its contribution to the CRTF in its manual rate filing.
74. OPIC recommended a 12.5 percent provision for the contribution to the CRTF.
75. GWAC recommended a 59.0 percent provision for residential property risks and a 59.4 percent provision for commercial property risks for the contribution to the CRTF, which were largely selected to avoid an overall rate change.
76. The Association's primary internal sources of funding to cover the costs of catastrophic events are the CRTF and the reinsurance protection it purchases.
77. The growth in the CRTF, which increased from approximately \$269 million at the end of 2000 to approximately \$383 million as of August 31, 2007, or about 42.5 percent, has lagged behind the growth in the overall size of the Association.
78. During this same period, the in-force exposure of the Association rose from about \$12.0 billion to \$53.7 billion, excluding commercial business interruption and additional living expenses coverage, an increase of almost 348 percent.
79. The ratio of the CRTF to the in-force exposure of the Association fell from 2.2 percent in 2000 to an estimated 0.6 percent at year-end 2007.
80. In the interim, the reliance on reinsurance has expanded greatly. In 2000, approximately \$17.8 million was spent on reinsurance coverage; the reinsurance contracts that were purchased for the 2007-2008 year are estimated to cost \$150.8 million, an increase of 747%.
81. Reinsurance is perhaps the most costly way for the Association to protect its policyholders and other stakeholders from the financial consequences of catastrophic events.
82. Every dollar contributed to the CRTF is available in its entirety to cover the financial consequences of catastrophic events.
83. It is therefore sound public policy to provide greater funding for the CRTF to permit less reliance on the more costly reinsurance option.
84. The rebuilding of the CRTF cannot be accomplished instantaneously, but rather requires, as recommended by GWAC, a long-term strategy for building capital in the CRTF.

85. This overall strategy will require increasing the provision for contributions to the CRTF in the rate structure while restraining reinsurance purchases to assure that the monies allocated for the CRTF do, in fact, reach the CRTF. This overall strategy may still require the purchase of reinsurance for the foreseeable future in order to protect policyholders along the coast and in other areas of the state, as well as the state's general revenue, from the financial consequences of major catastrophic events.
86. The first step in implementing this long-term strategy aimed at restoring the balance in the financing of the Association is an increase in the provision for the contribution to the CRTF.
87. If the Department relied on exactly the same procedures adopted in Commissioner's Order No. 06-1198 relating to the 2006 manual rate filing, a contribution to the CRTF of 18.1 percent would be produced. A larger contribution consistent with the strategy described in Finding Nos. 83-86 will promote more immediate and greater growth in the CRTF.
88. A contribution to the CRTF provision of 25 percent is reasonable and necessary.
89. The appropriate level of the Association's expenditure for reinsurance for the upcoming reinsurance contract period will be considered in 2008 in conjunction with a proposal from the Association for the purchase of reinsurance, in accordance with the Insurance Code §2210.453.

#### **Residential Property Rates**

90. Based on Finding Nos. 29, 55, 60, 72, and 88, the indicated rate change for residential property risks and classes of residential property risks is 8.2 percent.
91. Based on Finding No. 90, the Association's existing rates for residential property risks and classes of residential property risks should be increased by 8.2 percent.

#### **Commercial Property Rates**

92. Based on Finding Nos. 29, 55, 60, 72, and 88, the indicated rate change for commercial property risks and classes of commercial property risks is 5.4 percent.
93. Based on Finding No. 92, the Association's existing rates for commercial property risks and classes of commercial property risks should be increased by 5.4 percent.

**CONCLUSIONS OF LAW**

1. The Commissioner of Insurance has jurisdiction over this matter pursuant to the Insurance Code Chapter 2210.
2. The Insurance Code §2210.352(f) provides that the Commissioner shall approve, disapprove, or modify the Association's manual rate filing made pursuant to §2210.352(a) in writing on or before November 15 of the year in which the filing is made, or the filing is deemed approved.
3. The Insurance Code §2210.355(b) requires that the past and prospective loss experience within and outside this state of hazards for which insurance is made available through the Association's plan of operation, the Association's expenses of operation, and all other relevant factors must be considered.
4. The Insurance Code §2210.355(c) requires that rates must be reasonable, adequate, not unfairly discriminatory, and nonconfiscatory as to any class of insurer.
5. The Insurance Code §2210.356(a) requires that each rate approved by the Commissioner must be uniform throughout the first tier coastal counties.
6. The Insurance Code §2210.356(b) requires that the catastrophe element used to develop rates applicable to risks written by the Association must be uniform throughout the seacoast territory. The catastrophe element of the rates must be developed using: (a) 90 percent of both the monoline extended coverage loss experience and related premium income for all insurers, other than the Association, for covered property located in the seacoast territory, using not less than the most recent 30 years of experience available; and (b) 100 percent of both the loss experience and related premium income for the Association for covered property, using not less than the most recent 30 years of experience available.
8. The Insurance Code §2210.356(c) requires that the noncatastrophe element of the Association's residential property rates must be developed using: (a) 90 percent of both the monoline extended coverage loss experience and related premium income for all insurers, other than the Association, for covered property located in the catastrophe area of the seacoast territory, using the most recent 10 years of experience available; and (b) 100 percent of both the loss experience and related premium income for the Association for covered property using the most recent 10 years of experience available.

9. The Insurance Code §2210.356(d) requires that the noncatastrophe element of the Association's commercial rates must be developed using 100 percent of both the loss experience and related premium income for the Association for covered property, using the most recent 10 years of experience available.

**IT IS THEREFORE THE ORDER** of the Commissioner of Insurance that the foregoing findings of fact and conclusions of law be adopted.

**IT IS FURTHER ORDERED** that the 2007 manual rate filing for all types of risks written by the Association be modified consistent with the findings and conclusions set forth in this order and approved as modified.

**IT IS FURTHER ORDERED** that the manual rates to be charged by the Association for insurance for residential property risks written by the Association in accordance with the Insurance Code Chapter 2210 be increased by 8.2 percent from the January 1, 2007 rate level.

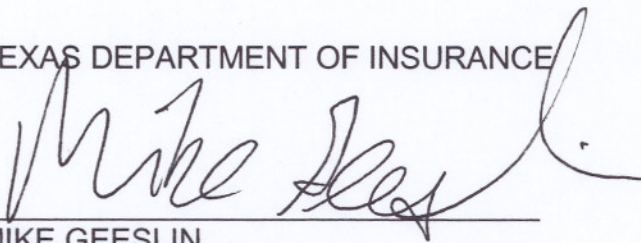
**IT IS FURTHER ORDERED** that the manual rates to be charged by the Association for insurance for commercial property risks written by the Association in accordance with Insurance Code Chapter 2210 be increased by 5.4 percent from the January 1, 2007 rate level.

**IT IS FURTHER ORDERED** that the Association's rates adopted in this order become effective February 1, 2008.

All relief not granted herein is **DENIED**.

**AND IT IS SO ORDERED.**

TEXAS DEPARTMENT OF INSURANCE



MIKE GEESLIN  
COMMISSIONER OF INSURANCE