No. 09-0927

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

**Date: November 16, 2009**

**Subject Considered:**
**Public Appeal Re-Hearing For Residential Property Insurance Filed by State Farm Lloyds**

**TDI Docket No. 2562-A**

**Order Modifying Rate Reduction Previously Determined by the Texas Department of Insurance and Directing the Payment of Refunds**

## I. INTRODUCTION

This is an appeal by State Farm Lloyds (SFL) filed pursuant to article 5.26-1 of the Insurance Code from a determination made by the Texas Department of Insurance (TDI or Department) on August 18, 2003, wherein it directed SFL to reduce by 12% the rate it previously filed for homeowners coverage on June 26, 2003. Based on the evidence in the record, the Commissioner finds that SFL met its initial burden of proof and established that the 12% rate reduction previously determined by TDI is confiscatory. The Commissioner further finds that the original rated filed by SFL on June 26, 2003, is excessive and that a reduction of 6.2% in the base rate will produce a rate that is just and reasonable and neither confiscatory nor excessive for the risks to which it applies. This reduction will be applied to the rate SFL charged its homeowner insureds for the period beginning September 7, 2003, and ending August 31, 2004. The Commissioner further finds that the rate SFL charged its homeowner insureds for the period beginning

September 1, 2004, and ending July 31, 2008, excluding new policies written from June 1, 2008, through July 31, 2008, was excessive and that a reduction of 3.4 % in the base rate will produce a rate that is just and reasonable and neither confiscatory nor excessive for the risks to which it applies. The Commissioner further finds that SFL is required to refund with interest the excess premiums it collected for the periods covered by this Order.

It is so **Ordered**.

## II. PROCEDURAL HISTORY

Pursuant to the then newly enacted SB 14,[1] SFL, previously a non-rate regulated insurer, filed its current rates as its "initial rates" with TDI on June 26, 2003, as required by the now expired article 5.26-1 which provided for a temporary rate regulation regimen. On August 8, 2003, TDI notified State Farm Lloyds that it had determined that its filed rates were "not reasonable for the risks to which they apply," and ordered a 12% reduction in the base rate.

SFL appealed the determination and a hearing was held before the Commissioner on September 2 and 3, 2003. To successfully overturn TDI's rate reduction determination, SFL was required by article 5.26-1 to show by "clear and convincing evidence" that the reduction ordered "would produce inadequate rates." The Commissioner upheld TDI's rate reduction determination, finding that a 12% reduction "will produce adequate base rates."

SFL sought judicial review of the Commissioner's Order as provided by article 5.26-1. SFL prevailed in its appeal, the district court finding that article 5.26-1 was unconstitutional on its face and as applied. It vacated the Commissioner's Order, finding it null and void.

TDI perfected its appeal from the district court's judgment to the Third Court of Appeals. The Court held that article 5.26-1's "proof provision" which required a showing that "the rate reduction specified by the department would produce inadequate rates" was unconstitutional on its face and as applied by the Commissioner in upholding the TDI's rate reduction order. The proof provision failed to pass constitutional muster because an "adequate" rate "only safeguards an insurer from rates that could lead to insolvency," but does not otherwise permit an insurer to realize reasonable returns on its investments and therefore could allow the imposition of confiscatory rates. *Geeslin v. State Farm Lloyds*, 255 S.W.3d 786, 795 (Tex. App.-Austin 2008, no pet.).

The Court found that the unconstitutional "inadequate" proof provision was severable, and reversing the district court on the point, upheld the rest of the statute. The Court observed that "[r]eading the statute as a whole and considering article 5.26-1 in light of articles 5.142 and 1.02, the parties are provided with detailed guidance for setting a rate . . . ." *Geeslin* at 799.

Finding that the "legislature intended article 5.26-1 to continue in effect to the final conclusion of all pending cases," the Court rejected State Farm's argument that remand was "not appropriate, warranted or legally authorized" and remanded the case to TDI for further proceedings consistent with its opinion. *Geeslin* at 806. Neither party filed an appeal.

Pursuant to the remand order, TDI on October 29, 2008, issued *Notice of Public Appeal Re-Hearing for Residential Property Insurance Rate Filed by State Farm Lloyds*.

On November 7, 2008, the Office of Public Insurance Counsel (OPIC) filed a Notice of Intervention pursuant to Insurance Code, section 501.153. Over the

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[1] Act of June 2, 2003, 78th Leg., R.S., ch. 206, 2003 Tex. Gen. Laws 907.

objection of SFL, OPIC was permitted to participate as reflected in Pre-Hearing Order No. 1 which was issued on November 24, 2008.

The appeal re-hearing began on March 30, 2009, and continued on April 1, 2, 15, and concluded on May 2, 2009. Elisabeth Ret and Amanda Jay Rapp represented the TDI Staff (Staff); Susan J Conway, Patrick Thompson, Pete Schenkkan and Andrea Stover appeared on behalf of State Farm Lloyds; and Deeia Beck represented OPIC.

## III. USE OF DATA NOT AVAILABLE IN SEPTEMBER 2003

Nearly six years have passed since State Farm Lloyds filed its "initial" rate under article 5.26-1's accelerated rate review structure and yet as of today we remain without a final, unappealable rate. During this period, policyholders have come and gone. The statute upon which this filing and appeal is based was set to expire on September 1, 2004; it clings to life for only as long as this matter remains unresolved, and then it will die for there are no other matters pending before it. Hopefully, its extension and this case will not survive another six years.

The passage of so much time, in addition to deferring a much needed resolution of the differences between the parties and doing justice to the ratepayers has caused other difficulties as well. The parties now know what they did not and could not have known at the close of evidence in the original appeal; they know how this movie ends. The temptation to use this information, or more precisely the data that became available after September 3, 2003, was great and all parties, while condemning its use by the other, fell victim to it when it advanced their position on any given issue. However great the temptation and however reasonable the use of retrospective evidence might appear to the ordinary

insured, it nonetheless has no business in a rate hearing, even one that occurs after the movie has ended. This is so, because ratemaking is a prospective endeavor.

Both TDI's and SFL's actuarial experts referenced the Casualty Actuarial Society's (CAS) "Statement of Principles Regarding Property and Casualty Ratemaking" (CAS Ratemaking Principles) and agree that insurance ratemaking is prospective in nature.[2] CAS Ratemaking Principle No. 1 states: "A rate is an estimate of the expected value of future costs."[3] This is necessary from a practical standpoint since insurance rates ordinarily are determined before the actual loss and expense costs are known. In this case, given the time elapsed, all parties now know what the *actual* loss and expense costs were for most of the period at issue.

Texas rating laws support the proposition that insurance rates are made prospectively. For example, article 1.02 sets out that a rate is excessive "if the rate is *likely to produce* a long-term profit that is unreasonably high . . . ." and "[a rate is] inadequate if the rate is insufficient to sustain *projected losses and expenses* . . . ."(emphasis added)[4] The law recognizes and requires that insurance rates be made prospectively and not retrospectively. Another consideration also comes into play here: it would be *unfair* to judge the reasonableness of any of the parties' *estimates of future costs* based on information that was unknowable in September 2003.

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[2] SFL Ex. 26 at 5; SFL Ex. 29 at 3; and TDI Ex. 69 at TDI 4207.

[3] TDI Ex. 45 at TDI 3243.

[4] Revised without substantive change as TEX. INS. CODE ANN. § 560.002 (Vernon 2009). Identical language is found in article 5.142 (expired December 1, 2004). Article 5.142 definitions are incorporated into the revived article 5.26-1.

The fact that ratemaking is a prospective endeavor does not preclude the consideration of all data that was unknowable in September 2003. There are three instances where the use of such data is fair, reasonable, and legally supported. First, rate indications change over time and given the lengthy history of this case, it is reasonable to use data that was unknowable as of September 2003 in order to determine refunds for periods *after* September 2004. There is no violation of the injunction that ratemaking be prospective if the data used to determine the rate is extant prior to the period the rates are used. For example, 2005 data could be used to determine rates for 2006. In the instant case, it is also necessary to *quantify* the total amount of refunds and interest due under this order. This calculation can only be completed by inputting data regarding premiums that were actually charged from September 2003 through July 2008, but obviously unknown in 2003.

Second, given the fact that the Commissioner's statutory obligations extend beyond ratemaking, it is reasonable and necessary for the Commissioner to consider information regarding SFL's *current* financial condition in evaluating whether it is prudent to require SFL to pay a given refund. Whatever SFL's financial condition was in September 2003, it is irrelevant to a consideration of the financial implications of refunds payable today.

Finally, there is one other occasion where the use of data unknowable in September 2003 is appropriate: to test whether a given actuarial hypothesis advanced is reasonable. An actuarial hypothesis would be, for example, testing whether there is a relationship between two variables. This is in contrast to *hindsight testing* which tests whether a particular value is reasonable in light of actual results. With these three notable exceptions, this opinion is grounded on

data as reflected in the record that was either known or knowable in September 2003.

*A. Use of Data That Was Unknown but "Knowable"*

Expected future income is one of several factors used in determining a rate indication.[5] Ordinarily, this income calculation is a fairly simple matter of taking current premium, projecting it into the future and adjusting for past rate changes, but as all participants have come to realize this is no ordinary rate case and it did not happen here because of the "premium error problem." On January 21, 2004, three months after the September 2003 hearing, SFL informed TDI that it had made an error when projecting its expected future premiums.[6] If accounted for, the effect of this error would *decrease* Staff's and SFL's 2003 estimate of SFL's expected future premiums by approximately 8%.[7] Both Staff and SFL proffered testimony based on post-hearing data to formulate rate indications that accounted for the error. OPIC did not; its expert relied only on data that was known as of June 26, 2003, and did not make any adjustment for SFL's premium error. In his direct oral testimony, OPIC's expert testified that even after such adjustments are made, TDI's original -12% reduction was, in his opinion, "still reasonable."[8] SFL described OPIC's failure to account for the premium error as "the most flagrant" example of OPIC's expert relying on erroneous data.[9] OPIC's expert hedged when asked whether he accepted the premium error correction. When asked if he agreed with SFL about the premium error correction, the building loss settlement adjustment, and the mold loss

[5] A rate indication is a series of actuarial calculations used to determine changes in an insurer's rates.

[6] TDI Ex. 33. There is nothing in the record to suggest that this was anything but an inadvertent error on the part of State Farm Lloyds.

[7] SFL Ex. 26 at 12.

[8] 5 Tr. at 23.

adjustment, Schwartz responded, "[l]et me just say I'm accepting what State Farm Lloyds has said on those three issues."[10] He added, however, that ". . . I've accepted their numbers without independently reviewing them . . . ."[11]

The record supports the claim made by SFL and accepted by Staff that the existence of the premium error was "knowable."[12] The corresponding adjustment made by these parties to future premium income was reasonable under the circumstances and was appropriately made.

SFL also made an adjustment to its projected Other Extended Coverage (OEC) losses using "knowable" information SFL submitted to TDI in response to a 2001 TDI Data Call specifically directed at mold losses. This adjustment was accepted by Staff's expert witness. SFL's witness stated that, although this information was available at the time of the rate hearing in September 2003, he did not become aware of it until mid-2005.[13]

With these exceptions, the record is clear that no party calculated a rate indication for the September 2003 to September 2004 period that relied on data that did not exist as of the date of the September 2003 hearing.[14] Both TDI and SFL presented initial rate indications based entirely on the premium, loss, and expense estimates these two parties originally presented at the September 2003 rate hearing. That is not to say that the parties' calculations or emphasis of particular data remained unchanged. For example, in the September 2003 rate

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[9] 5 Tr. at 8.

[10] 5 Tr. at 150.

[11] *Id*. at 151.

[12] SFL Ex. 26 at 8, 98-99.

[13] SFL Ex. 26 at 12, 22-25. SFL also made other, minor, adjustments, including an adjustment for a loss settlement clause approved after the filing was made, but before the original September, 2003, hearing commenced. A complete list of all changes is shown in SFL Exhibit 26, pages 9-10.

[14] This was not the case, however, with respect to indications for a rate after September 2004.

hearing, Staff presented a range of rate reductions based on four rate indications.[15] Each rate indication used different inputs: two were calculated using SFL's non-catastrophe loss and loss adjustment expense estimates; and two were based on non-catastrophe loss and loss adjustment expense estimates that Staff's witness, Dr. Mark Crawshaw, calculated independently. In this proceeding, Crawshaw rejected SFL's non-catastrophe loss and loss adjustment expense estimates as no longer reasonable, relying instead on his independent calculation for these inputs.[16]

*B. Use of "Hindsight" Testing*

Notwithstanding each party's objections to its use, all litigants to some degree offered evidence based on data that was not knowable in 2003, and which does not fall within the three exceptions noted above. The parties' preferred vehicle for the use of this data was an analytical process known as "hindsight testing" or "hindsight review." Hindsight testing is where an actuary tests the accuracy of prior projections regarding expected future costs (or income) in the full light of actual results. It can be a useful actuarial tool for evaluating the soundness of assumptions that underlie projections.[17] The problem with deploying it here, of course, is the fact that the actual results for 2004, 2005 and later were unknown to the parties in 2003. It therefore would be fundamentally unfair to evaluate any of the experts' actuarial projections based on a test that none of them could have performed in 2003. For this reason, no evidence using hindsight testing was given any weight.

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[15] Staff's rate indications were -11.2%, -14.0%, -18.8%, and -21.3%. This produced a range of reductions of -11.2% to -21.3%. *See* TDI Ex. 63 at TDI 3954 – 3955.

[16] TDI Ex. 69 at TDI 4219.

[17] SFL Ex. 26 at 92.

Both Staff and SFL used hindsight testing to either rebut the testimony of the other party's witnesses or to advance or support the testimony of their own witnesses. Crawshaw provided expense and pure premium[18] data for 2005-2006 to both support his projections and question the reasonability of SFL's projections. In his rebuttal testimony, he compared SFL's 2003 loss projections, Staff's 2003 loss projections and the actual resulting losses in 2004-2006 in order to refute SFL's testimony that Staff's projections had "only the slightest likelihood of being an accurate projection of the future."[19] In SFL's rebuttal testimony, Mr. Robert Kelley used SFL's actual fixed expense data for 2006-2008 to rebut Staff's testimony regarding this rate provision.[20] Kelley, also in rebuttal compared the pure premium projections Crawshaw made in the 2006 SFL rate case with the actual pure premiums that emerged in 2008.[21]

## IV. State Farm Lloyds Met Its Initial Burden of Proof by Default

SFL met its initial burden of proof to show, by clear and convincing evidence, that the 12% rate reduction determined by the TDI as set out in its notice to SFL on August 8, 2003, will produce a confiscatory rate. A rate is confiscatory if it does not produce a reasonable profit in relationship to the insurance coverage provided. SFL succeeded in meeting its burden by default[22] because TDI

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[18] Pure premium refers to the average amount of loss per policy.

[19] TDI Ex. 76 at TDI 4603-4604 and 4652-4660.

[20] SFL Ex. 27 at 27.

[21] SFL Ex. 27 at 22-23.

[22] It should not be inferred from this determination that the record was silent on this issue. SFL offered testimony from three different expert witnesses that the original rate reduction directed by Staff would produce inadequate and thus confiscatory rates. [A rate that is inadequate, i.e., "insufficient to sustain projected losses and expenses to which the rate applies." Insurance Code article 5.142 (2)(b)(2) is *ipso facto* "confiscatory."] In his pre-filed direct testimony Kelley stated that "the Commissioner's ordered 12% reduction for SFL is unjust, unreasonable and inadequate." SFL Ex. 26 at 86. Michael J. Miller concurred in this opinion stating that "[a]ny reduction below the SF L1oyds' rates in effect in June 2003 would have resulted in inadequate and actuarially unsound rates." SFL Ex. 29 at 5. Dr. David Appel opined in pre-filed

withdrew its original determination that a 12% rate reduction was required in order for SFL's rates to conform to the Code.

Acknowledging the necessity of accounting for the premium error[23] and reversing its previous position on a 2% contingency load,[24] Staff chose not to offer any testimony in support of its original 12% rate reduction. After adjusting for these factors and for certain others[25] and for the inordinate passage of time between SFL's original filing and the instant proceeding, Staff put forth a revised analysis "that SFL's rate should be reduced by 9.2% from September 7, 2003, through June 30, 2004, by 7.3% from July 1, 2004, through June 30, 2005, and by 5.1% from July 1, 2005, to June 30, 2006."[26] Staff, in its closing argument, was correct to point out "that no purpose is served by having the Commissioner examine a TDI reduction that was based on data which SFL has since revealed to be flawed."[27]

OPIC disagrees with the formulation of the issue previously ordered in this case, arguing that *Geeslin* requires SFL to prove that the rate *it* filed meets the statutory standard, rather than proving that the rate reduction ordered by TDI does not. While the *Geeslin* opinion does contain language that lends support to this interpretation, elsewhere in its opinion the Court makes clear that the subject matter of the appeal is "the rate reduction specified by TDI."[28] What was

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direct testimony that the 12% "would produce rates that were inadequate, and could threaten the SFL's financial integrity and its ability to operate successfully in Texas." SFL Ex. 37 at 37.

[23] TDI Closing Argument at 5.

[24] 3 Tr. at 168.

[25] Staff updated the non-catastrophe loss and LAE provision to account for SFL's Building Loss Settlement form; revised the expected the hurricane loss and LAE provision to reflect corrections SFL made; and updated the catastrophe and stop loss reinsurance provision. TDI Ex. 69 at TDI 4218.

[26] TDI Closing Argument at 3.

[27] *Id.* at 5, fn. 14.

[28] *Geeslin* at 793.

judicially excised from the statute was not the matter of who bears the burden of proof, but rather the language that precluded an insurer from establishing that the rate reduction determined by Staff could produce confiscatory rates. To read the opinion otherwise overwrites the unambiguous language of the statute and would lead to the absurd and linguistically insupportable result that SFL has the duty to appeal from its own rate filing. Further, since the statute vests in the Department the "exclusive jurisdiction to determine a rate under this subsection,"[29] OPIC has no standing to object to the Department's withdrawal of its original rate reduction.

Given the fact that SFL met its initial burden of proof, the issue remaining for adjudication in this matter is the determination of a rate chargeable by SFL which is just and reasonable and neither confiscatory nor excessive for the risks to which it applies.[30] None of the parties bear either the burden of production or persuasion on this issue as those terms are ordinarily understood. The Commissioner will determine a rate. If SFL believes the rate ordered is confiscatory, it can petition for judicial review as provided by article 5.26-1.

## V. The Problem of Duration, Risk and Rates

> If you can look into the seeds of time, and say which grain will grow and which will not, speak then unto me.
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> — *Macbeth*: Act 1, Scene 3

As fully set out in Section VI, the Commissioner finds that the rate SFL filed on June 26, 2003, was excessive for the risks to which it applied. Ordinarily and absent an appeal, such a finding would be dispositive of the matter of liability.

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[29] TEX. INS. CODE art. 5.26-1 (2)(b)

In the ordinary homeowners' rate case, the applicable risks covered by such an order would be confined to those projected within a fairly short duration, most likely a year. That was the parties' assumption in constructing their rate indications during the first hearing. But as the parties and in fact all participants have sadly come to appreciate, this is no ordinary case. Here, for reasons that include a painfully long appellate process which ended in the partial dismemberment of the statute under which the original order was issued, and a remand and a rehearing of issues first litigated in September 2003, the risks covered are not confined to the usual duration, but in fact continue over for a period of at least five years. This is so because SFL went without an approved rate until August 2008.

The problem here is that no rate, under generally accepted actuarial practice or the applicable rating statutes, was ever expected to account for risks that extend over such a long duration. Risk changes over time and this stubborn fact must be dealt with. It is into this morass that we must venture, unaided by anything that even closely resembles precedent and craft some resolution to this problem that comports with the constitution, the applicable statutes, and common sense; all the while doing justice to SFL, its insureds and the public interest.

Staff and SFL acknowledge the problem[31] and have proposed differing rating methodologies to deal with it. OPIC has not. It advances the argument that "[i}t is customary for an insurance rate to remain in effect until superseded by another properly implemented rate" and that SFL "did not legally implement new rates

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[30] The rate standard of "not unfairly discriminatory" as set out in various sections of the Insurance Code has not been an issue in this case.

[31] To be clear, SFL has never abandoned its position that the rates it filed on June 26, 2003, were reasonable and legal. However, it acknowledges that in the event a reduction is ordered, the problem of duration must be accounted for.

until 2008,"[32] obliquely suggesting that SFL chose, for whatever untoward reason, to deliberately delay filing new rates. This in fact was not the case; SFL made two rate filings during this period and each was rejected.[33] While it is undoubtedly true that as a general proposition rates stay in effect until superseded, under the unique facts of the instant case, this observation is entirely beside the point. But the heart of OPIC's argument against developing a rating methodology to deal with the problem of duration is that such a methodology is, in its opinion, unnecessary because SFL rates remained at the same level of excessiveness for the entire period. Relying in part on retrospective data that the Commissioner has made clear in Section III will not be considered, OPIC argues that:

> SFL's experience, both at the time of the filing and now, demonstrates these rates were continually excessive between September 7, 2003 and August 1, 2008. In 2003, premium and loss trends moved in "lockstep." Stability in the relationship between losses and premiums suggests that the amount of rate excessiveness was *constant* for periods after September of 2003. *This projection is confirmed by SFL's actual experience subsequent to the September 2003 hearing*. The existence of a flat or negative loss ratio trend, both prior to the 2003 hearing and for subsequent years, shows that SFL's rates were excessive *by the same amount* for the entire period the rate was in effect. (citations omitted) (emphasis added)

Office of Public Insurance Counsel's Brief on Refunds and Refund Methodologies, pages 3-4.

In addition to relying on data that for all practical purposes is outside this record, OPIC's argument goes against the great weight of the evidence and is therefore unsupportable. If anything, the record shows, as fully set out below, that the rate's excessiveness did not remain constant, but declined over time.

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[32] OPIC's Brief on Refund and Refund Methodologies at 2.

[33] On May 31, 2006, SFL submitted TDI filling numbers 9212471923 and 9212471926. Both filings were disapproved on July 21, 2006, under Commissioner's Order Nos. 06-0745 and 06-0746. TDI Ex. 22.

*A. The Initial Rate Period*

The original appeal hearing on the 12% rate reduction was held on September 2 and 3, 2003. In that hearing, experts for both Staff and SFL[34] presented rate indications based on the assumption that the rate would apply to policies with effective dates between September 2003 and September 2004. Nearly five and one-half years later, this re-appeal hearing was held to re-litigate the original rate reduction order. In the present hearing the same parties plus OPIC, and many if not all of same expert witnesses, re-testified advancing much of the same rate indications based on the assumption that what was then appropriately characterized as the "initial rate filing" would apply for one year. In addition, these same witnesses, with the exception of OPIC's, testified regarding what indications were appropriate for a rate to be applied after the initial period, although they disagreed regarding its duration. Since the testimony of these experts naturally gravitated to what one might call two separate data sets, one for an initial period and the other for a subsequent period, the Commissioner finds no reason to upset this logical and natural order. The Commissioner, therefore, will determine two rates: one, for "the initial period," September 2003 through September 2004; and a separate rate for a "subsequent period," the duration of which will be discussed below. To do otherwise, would make an already difficult record even more challenging.

*B. The Subsequent Rate Period*

The remaining question is the rate to be charged for policies with effective dates *after* September 1, 2004. The same constitutional and statutory standards apply

[34] OPIC did not participate in the original hearing.

to these policies as well; the rate must be just and reasonable and neither confiscatory nor excessive for the risks to which it applies.

The parties disagree regarding the duration of the "subsequent period." SFL and OPIC take the position that the period extends through July 31, 2008, the effective date for SFL's first approved rates.[35] Staff put forth an ending date of September 30, 2006, based on the testimony of Crawshaw. He opined that after October 1, 2006, SFL's rates "ceased to be excessive"[36] and then became "inadequate."[37] Crawshaw performed no actuarial analysis in reaching this conclusion, but instead relied entirely on the findings of fact and conclusion of law set out in a Proposal for Decision (PFD) issued on November 16, 2007, by Administrative Law Judges James W. Norman and William G. Newchurch regarding an SFL rate filing made in May 2006.[38] The PFD was never adopted. The question before SOAH in that case was whether the rates SFL filed in *2006* were excessive. Those rates were never used by SFL. Subsequent to the issuance of the PFD, SFL filed new rates which were approved by the Commissioner. Whether a set of rates filed in 2006, and never charged by SFL, were excessive is not relevant to whether SFL's 2003 rates are excessive. Although very well written, the PFD has no probative value in this case. Dr. Crawshaw's opinion is without foundation.

The parties agree and the record is uncontroverted that SFL continued to use the rate it initially filed on June 26, 2003, until it ultimately obtained the Commissioner's approval for a new rate, effective June 1, 2008, for new business

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[35] Commissioner Geeslin approved SFL's rates filed on December 17, 2007. TDI Ex. 21 at TDI 1719 and OPIC Ex 1 at 33.

[36] TDI Ex. 69 at TDI 4237. 3 Tr. at 153.

[37] 3 Tr. at 153.

[38] Queried regarding the basis of his opinion, Crawshaw testified that "[w]ell, I think I'm relying on the outcome of the 2007 rate -- rate hearing which was to do with the 10/1/2006 rate filing." 4 Tr. at 49. He

and August 1, 2008, for renewal business. The "subsequent period" therefore runs from September 1, 2004, through July 31, 2008, excluding new policies written from June 1, 2008, through July 31, 2008.

## VI. INITIAL RATE REDUCTION

### *A. Projected Earned Premiums*

Purpose

The purpose of the provision for projected earned premiums is to determine the amount of premiums SFL can be expected to charge during the period in which the rates are expected to be in effect. This, combined with an estimate of the expected costs associated with writing an insurance policy, is used to determine the necessary change to the rate SFL filed on June 26, 2003.

Testimony

Staff used a projected earned premium of $1,041.59, SFL $1,041.74, and OPIC, $1,131.00. Both SFL and Staff adjusted the projected earned premium used in the 2003 proceeding to correct SFL's premium error; OPIC did not. In its testimony, SFL stated there were inconsistencies between Staff's projected earned premiums and their projected non-catastrophe losses.

Analysis

There is no evidence that SFL's premium error was anything other than a *bona fide* mistake. Failure to correct for the premium error would significantly overstate SFL's expected future premium income and thereby skew any rate calculation based upon it. Therefore, it is not only reasonable, but essential, to

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continued: "So that's the basis for me saying that -- 10/1/2006 the rates were not excessive because the ALJs were saying they needed to be increased a little bit …." 4 Tr. at 49.

correct for it. OPIC's projected earned premium did not correct for this error and is, therefore, unreasonably high. SFL's criticism of Staff will be addressed in Subsection B, *Non-Catastrophe Loss and Loss Adjustment Expenses (LAE).* It is reasonable to include a provision for projected earned premiums of $1,041.59.

*B. Non-Catastrophe Loss and Loss Adjustment Expenses (LAE)*

Background and Purpose

The purpose of the non-catastrophe loss and loss adjustment expense (LAE) provision is to account for normal losses and the claim adjusting expenses associated with those losses. For the most part, these losses relate to perils covered under a homeowners policy that are not catastrophic in nature.[39] Such perils include: fire, theft, water damage, and liability.

Both Staff and SFL provided an analysis for each of these perils: (1) Fire, Other Than Lightning (OTL); (2) Fire due to Lightning (Lightning); (3) Wind/Hail; (4) OEC[40]; (5) Crime; and (6) Liability. SFL's witness Kelley testified that a separate analysis by peril can reveal trends and insights not revealed using an all perils analysis. For the OEC peril, SFL also adjusted the historic data to reflect the water coverage provided under its approved homeowners policy form. SFL utilized statistically coded information and TDI's June 30, 2001, mold data call to eliminate claims involving mold and dwelling foundation losses, and relied upon claim employee estimates to remove claims and losses due to continuous or repeated seepage of water.

[39] SFL included the peril of wind and hail as one of the perils for non-catastrophe loss. While the peril of wind and hail is often associated with catastrophes, the wind and hail losses used for their non-catastrophe loss analysis were those wind and hail losses not associated with catastrophic events.

[40] OEC stands for "Other Extended Coverages." Kelley testified that OEC *includes* specified covered losses due to water and freezing. SFL Ex. 26 at 18.

The non-catastrophe loss and LAE provision generated much controversy and heated actuarial debate. The differences revolved around five related issues: (1) the method used to project the losses; (2) whether a loss ratio analysis is reasonable; (3) the effect of deductibles and whether the experts considered this effect consistently in their projections; (4) whether there is a negative correlation between frequency and severity; and (5) whether Staff's witness arbitrarily changed his position by rejecting SFL's non-catastrophe loss projections as unreasonable in 2009 when, in 2003, he accepted them as reasonable. SFL recommended a pure premium (i.e., average loss per policy) of $262.29, Staff $236.77, and OPIC $267.56. All parties included an amount for loss adjustment expense, resulting in the following non-catastrophe loss and LAE provisions: SFL $332.45; Staff $300.10; and OPIC $339.13.[41]

Method Used to Project Losses

SFL's witnesses, Kelley and Michael J. Miller, provided a frequency/severity[42] analysis in support of SFL's non-catastrophe loss and LAE provision. Kelley testified, and Miller concurred, that frequency and severity need to be separately analyzed because separate analyses can reveal patterns in the data that may not be discerned when analyzed together using a pure premium[43] analysis. Miller testified that while it is not wrong to analyze pure premiums, it is essential that frequency and severity also be analyzed separately. SFL calculated its projected

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[41] *See* SFL Ex. 26 at 116 for the $262.29 value. $236.77 calculated as $300.10 / 1.2675. *See also* TDI Ex. 69 at TDI 4266. *See* OPIC Ex. 1 at 21 for the $267.56 value. *See* SFL Ex. 26 at 112 for the $332.45 value. *See* TDI Ex. 69 at TDI 4266 for the $300.10 value. *See* OPIC Ex. 1 at 18 for the $339.13 value.

[42] Frequency refers to the average number of claims per 100 policies. Severity refers to the average dollar amount of losses per claim.

[43] Pure premium refers to the average dollar amount of losses per policy. Thus, using the definitions of frequency and severity *supra fn. 42,* pure premium is (frequency x severity) / 100.

frequencies by taking the average of the last 4 to 20 frequency observations,[44] a method that assumes a 0% frequency trend in the future. SFL calculated projected severities by examining historic Texas severity trends, weighting them with countrywide severity trends, and projecting those trends into the future. Final pure premiums were calculated using the projected frequencies and projected severities.

Staff's witness, Crawshaw, provided a pure premium analysis in support of Staff's non-catastrophe loss and LAE provision. For most perils, he projected future pure premiums based on historic pure premium trends. For the wind peril, he calculated the projected pure premium as the average of the last 12 observations. For the OEC peril, he calculated his projected pure premium by weighting the pure premium projections after first including and then excluding data for 2002. Crawshaw testified that a pure premium analysis was a common approach and was used by Allstate Texas Lloyds in its SB 14 filing. He contended that SFL's frequency/severity analysis ignored "correlations"[45] between frequency and severity, and assumed premium and loss trends were independent of each other.

Loss Ratio Analysis

In his pre-filed testimony, Crawshaw presented a loss ratio analysis which he claimed confirmed the results of his pure premium analysis. Crawshaw first calculated the loss ratios for each peril for two years of data by dividing the pure premium by the average premium, and averaged the two loss ratios. He then multiplied the average loss ratio by SFL's projected earned premium which

[44] For most perils, SFL used the last 4 points of data. For Crime and OEC, SFL used the last 12 and 20 points of data, respectively. Each frequency, severity, and pure premium observation contained 12 months of aggregate data, calculated at quarterly intervals on a rolling 12-month average basis. SFL Ex. 26 at 20.

resulted in projected pure premiums. He testified these projected pure premiums were similar to the projected pure premiums resulting from his original analysis. The assumption underlying this method is that "the rate of increase in non-catastrophe losses is consistent with the rate of increase in premiums."[46] Crawshaw further testified that "[t]heoretical and empirical data for Texas Homeowners insurance indicate that premium and loss trends should be reasonably similar."[47] His theoretical basis was non-catastrophe losses are dependent upon many variables, such as deductible, type of risk, and amount of insurance, and since SFL's rating plan is meant to be inflation sensitive and risk-based, factors that affect losses will also affect premiums. He concluded the ratio of expected losses to premiums at current rates is not expected to vary significantly over relatively short time periods. The empirical data he presented for this contention was: (1) in the context of prior benchmark hearings the Commissioner and industry experts have found this to be the case;[48] (2) SFL's internal data show this to be true;[49] and, (3) SFL's own projected loss and LAE ratios confirm the point.[50]

SFL vehemently disagreed with Crawshaw's contention. Kelley stated that this theory was theoretically flawed and demonstrably wrong. It was theoretically flawed because there are factors affecting loss trends that do not affect premium

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[45] TDI Ex. 69 at TDI 4226.

[46] TDI Ex. 69 at TDI 4223.

[47] *Id.*

[48] In Crawshaw's pre-filed written testimony, he referenced TDI Exhibit 54 (Commissioner's Order #01-0980). In his oral testimony, he pointed to Findings of Fact No's. 28, 31, and 32. TDI Exhibit 54. *See also* TDI Ex. 69 at TDI 4224 and 3 Tr. at 186, 187.

[49] TDI Ex. 69, Attachment MC-4 at TDI 4252 shows the ratio of pure premium to average premium at current rate level for the years 2002-2005.

[50] Crawshaw referenced SFL Exhibit 27, page 61, second row, labeled "Non-Catastrophe Loss and loss adjustment expense," which provides the ratio of SFL's projected loss and loss adjustment expenses to its

trends, such as the phenomenon of policyholders acquiring more expensive home electronic devices, the increased use of wood flooring in homes, and factors that affect claim frequency.[51] He also testified that some factors, such as increased costs of construction, do not affect loss trends and frequency trend the same. He testified that SFL's data does not support the theory that loss ratios change gradually over time. In support of this point, he provided SFL's "Non-Catastrophe Incurred Loss Ratios To Earned Premium."[52] Miller also took strong exception to Crawshaw's loss ratio analysis. He testified that Crawshaw's loss ratio method did not verify the reasonability of his pure premium projections, but rather he selected his pure premium projections consistent with his hypothesis that premiums and losses tend to move together.

In Crawshaw's oral testimony, he conceded Kelley's point that individual factors do not have the same effect on premiums as they do on losses, but argued when you look at the aggregate effect of all the factors affecting premiums and all the factors affecting losses, you find that losses and premiums move similarly.

The Effect of Deductibles

SFL and Staff agreed that SFL's frequency, severity and pure premium data were affected by deductibles that had increased over the period of time the historic data covered. SFL and Staff testified that the effect of increasing deductibles is to decrease frequency trends and increase severity trends. SFL also stated that increasing deductibles affect premium trends. Where Staff and SFL disagreed

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projected average earned premium for 2003-2007/2008. He noted the first column excluded "the OEC endorsements," whereas the others did not. 3 Tr. at 193-194.

[51] Kelley listed such things as the number of fires, lightning strikes, hailstorms, thefts, and the number of liability claims. SFL Ex. 65 at 1.

[52] SFL Ex. 27 at 7. This exhibit provided the ratio of SFL's actual "losses" to actual earned premiums for the years 2005 to 2008 (with 2008 data through November 30), but there is substantial uncertainty whether the "loss ratios" presented by Kelley are actually loss ratios.

was over how to consistently treat the impact of deductibles when determining the non-catastrophe loss and LAE provision.

SFL testified it consistently projected its premiums, frequencies and severities assuming no further shift in deductibles, whereas Staff did not. SFL testified that by projecting a 0% frequency trend, it assumed no further deductible shifts. Its premium trends assumed no further deductible shifts, and it assumed no further deductible shifts by projecting its severities using "a less aggressive rate of severity projection than I otherwise would have."[53] SFL criticized Staff because Staff's pure premium projections assumed deductibles would continue to increase in the future, but Staff's premium projections were based on the assumption that deductibles would not continue to increase in the future. Kelley testified SFL's average deductible increased by $200 from 2001 to 2002. He estimated the impact of this change was approximately a 5% decrease in premium.

Staff's witness testified that SFL just assumed the decrease in claim frequencies seen in the data was entirely due to changing deductibles.[54] Crawshaw testified SFL did not investigate how much of the decrease in claim frequencies was due to deductibles and how much of the decrease was due to other factors. While he believed deductibles were indeed changing, he cited other factors that could affect frequencies, such as changes in the claim filing behavior of claimants, and improved building codes. He also criticized SFL's method for inconsistently treating the deductible effect for frequency and severity. Crawshaw contended that SFL made no adjustment in their severity projections to reflect the "extra

[53] Kelley. 2 Tr. at 179.

[54] 3 Tr. at 178-179.

kicker"[55] (i.e., increase) in severity trends caused by increasing deductibles. Although not relevant, he also testified that two administrative law judges had reached similar conclusions regarding SFL's methodology in a prior homeowners insurance rate case.[56]

In response to Crawshaw's testimony, Kelley replied that it is not realistic to forever assume frequencies will decrease. Eventually, he testified, frequency trends will flatten out. While he conceded there may have been changes in claiming behavior, and this would affect frequency trends, he testified in his experience this phenomenon typically does not extend for long periods of time.

Negative Correlation Between Frequency and Severity

In his pre-filed direct testimony, Crawshaw presented a statistical analysis which showed statistically significant correlations between frequency and severity for some perils.[57] He concluded that "SFL's own data shows that claim frequency and claim severity are not independent of each other but instead are generally negatively correlated with each other. In other words, severity tends to increase when frequency decreases and vice versa."[58] In his oral testimony, Crawshaw clarified he is not asserting there is an inherent negative correlation, but instead his testimony is related solely to SFL for the period in question. The explanation he gave for this relationship is the deductible. He stated that since frequency is related to the deductible and severity is related to the deductible, frequency and severity are related to each other through the deductible. In response to the

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[55] 3 Tr. at 179.

[56] Specifically, Crawshaw referenced Finding of Fact No. 57 in the proposal for decision issued by the Hon. James W. Norman and the Hon. William G. Newchurch. SOAH Docket #454-06-3176.F, *In the Matter of State Farm Lloyds*, submitted as TDI Exhibit 55.

[57] Crawshaw found statistically significant correlations for the perils of "Fire OTL," "Wind/Hail" and "Liability." TDI Ex. 69 at TDI 4250 and TDI 4285-4291.

[58] TDI Ex. 69 at TDI 4226.

criticism SFL made regarding the need for Staff to show causality,[59] Crawshaw countered that ASOP No. 12, *Risk Classification*, specifically states it is not necessary for an actuary to establish a cause and effect relationship in order to use a specific risk characteristic for insurance rating.[60] Crawshaw pointed to common rating variables, such as gender, credit scoring, and marital status, that are used to rate insurance policies. Crawshaw observed that no one would argue there is a direct causal relationship between these rating variables and insurance claims, but there is a statistical relationship.[61]

SFL's took very strong exception to Crawshaw's statistical analysis and conclusions. Both Miller and Dr. David Appel criticized Crawshaw for not providing a causative reason for the negative correlation.[62] Miller testified Crawshaw's hypothesis was "illogical"[63] and would lead to ridiculous conclusions such as the occurrence of home fires could be eliminated by raising the cost of drywall and roofing materials. While Miller conceded that shifting deductibles could cause some dependence between frequency and severity, he testified that it would only have a "minimal"[64] impact on the data.

Staff's Change in Position on the Reasonableness of SFL's Non-Catastrophe Loss and LAE Provision

In the original 2003 hearing, Crawshaw presented four rate indications resulting in a range of recommended rate reductions. These reductions ranged from

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[59] *See infra* p. 25.

[60] *See* SFL Ex. 13 at 4, paragraph 3.2.2. "Causality"

[61] 3 Tr. at 200-201.

[62] These criticisms were made prior to Crashaw's oral testimony. Miller. SFL Ex. 30 at 14-15. Appel. SFL Ex. 38 at 11-12. These comments are in their pre-filed rebuttal testimony.

[63] SFL Ex. 30 at 6-8.

[64] *Id*. at 13-14. Miller testified between 1998-2002 SFL's average deductible only increased by $85 and each $100 increase in deductible would result in 1.2% decrease in frequency and a 0.4% increase in severity.

-11.2% to -21.3%. At that time Crawshaw had concerns that SFL's non-catastrophe loss and LAE provision may be overstated, but accepted it as the upper end of a range of reasonable alternatives.[65] He used this provision to develop the low end (i.e., the -11.2% end) of his range of recommended rate reductions. For the high end of his range, Crawshaw relied on his own independent projections. In this proceeding Crawshaw rejected SFL's non-catastrophe loss and LAE provision as unreasonable, and instead relied solely on his independent projections which he presented at the 2003 hearing.[66]

SFL took exception to this change in position, challenging it as "arbitrary"[67] and argued that Staff should be supporting a rate reduction no lower than -3.6%.[68]

In his pre-filed testimony, the reason Crawshaw gave for changing his prior position was that SFL's non-catastrophe loss projections can no longer be considered reasonable in the context of the revised premium. Specifically, he said, the loss ratios produced by SFL's non-catastrophe loss projections are no longer reasonable in light of SFL's historical experience and expected future trends.[69] In his oral testimony, Crawshaw testified that in conjunction with SB 310, he performed a preliminary review of SFL's homeowners rates in early 2003 and concluded SFL's rates were overstated by -13.4%.[70] When he performed his analysis in the summer of 2003, he did not reject SFL's non-catastrophe loss

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[65] 4 Tr. at 164.

[66] Crawshaw made other changes to his analysis to reflect information that was "unknown but knowable" at the time of the 2003 hearing. These changes were not the subject of any controversy. *See supra*, fn. 25.

[67] Kelley. SFL Ex. 27 at 2-3.

[68] *Id.* SFL testified the -3.6% results from applying the premium correction to Crawshaw's original low end rate reduction of -11.2%, citing Crawshaw's deposition.

[69] TDI Ex. 69 at TDI 4219.

[70] SB 310 by Fraser, 78th Texas Legislature, Regular Session, amended the Insurance Code by adding article 5.141, which required the Commissioner of Insurance to issue a summary report to the 78th Legislature that contained a review of insurer's rates.

projections because the information he was provided in totality, including the loss ratios resulting from SFL's non-catastrophe loss projections, and the resulting rate indication, was within a reasonable range based on his prior review of SFL's rates. He testified that when the premium information turned out to be inaccurate, those checks no longer provided a valid reason for considering SFL's loss projections to be reasonable.

OPIC's Testimony

OPIC's expert, Allan Schwartz, did not analyze SFL's historical non-catastrophe loss data by peril; instead he analyzed SFL's data for all of the perils combined. In his testimony he analyzed frequency, severity, and pure premium trends over the last 2 to 7 years and selected a pure premium value of $267.56 per policy. Unlike SFL and Staff, OPIC did not make any adjustments for information that was unknown as of September 2003 but theoretically could have been known; specifically, he did not adjust the non-catastrophe loss and LAE to contemplate SFL's building loss settlement endorsement. In his testimony, Schwartz also expressed concern that SFL had not completely removed "the one-time unusual losses during 2002" from its OEC data. [71]

Loss Adjustment Expenses (LAE)

Since projected pure premiums include only losses and not their associated claims adjusting expenses, it is necessary to include LAE before applying the results to the ratemaking formula. There was no controversy on how to include these expenses. Everyone calculated the corresponding LAE by multiplying the projected pure premium by a factor of 0.2675.

[71] OPIC Ex. 1 at 15.

Analysis

The pure premium and the frequency/severity approaches are both commonly used to project non-catastrophe losses according to testimony provided by Staff and SFL. OPIC did not dispute the point. The Commissioner finds the hypothesis that frequency and severity are *inherently* negatively correlated is not a fundamental assumption of the pure premium method. While the Commissioner is persuaded by SFL's argument that the inherent negative correlation hypothesis would produce absurd results, it would be equally absurd to conclude that this hypothesis is a fundamental assumption of the pure premium method used by Crawshaw. If this were in fact the case, it is inconceivable that the pure premium method would have gained such wide acceptance in Texas and elsewhere. For example, one of the largest homeowners' insurers in Texas adopted this methodology in their SB 14 filing.[72] Finally, if the inherent negative correlation hypothesis was indeed a fundamental assumption of the pure premium method, presumably Miller himself would never have used it, which he testified he sometimes did.[73] Likewise, the Commissioner rejects Staff's argument that the frequency/severity method ignored correlations in the data. While the Commissioner does find flaws in the assumptions SFL used to project its frequencies and severities, he finds no flaws in the method itself.

Both Staff and SFL presented "retrospective" evidence to either support or refute the contention that loss ratios tend to be reasonably stable over short periods of time. In most cases the Commissioner has rejected the use of "retrospective" evidence, but the data presented on this issue by both parties' falls into the Commissioner's exception, i.e., evidence on whether a particular hypothesis is

[72] *See supra* p. 20.

true or untrue. During the cross-examination of SFL's witness Kelley, Staff contended that the "actual loss ratios" presented by Kelley were not loss ratios. While Kelley was unwilling to concede the point in full, the evidence strongly suggests that the data presented by Kelley to refute Crawshaw's contention were not "actual loss ratios," but rather "actual loss and loss adjustment expense." ratios.[74] This somewhat weakens the strength of the empirical evidence SFL provided. In addition, Staff pointed to evidence suggesting that SFL's own witness, Kelley, had projected losses that produced loss ratios that showed some variation, but no pattern of increases or decreases.[75] Kelley was given the opportunity to refute this, but did not. While the Commissioner does not dispute SFL's contention that there are factors affecting losses which do not affect premiums, there is sufficient empirical evidence to suggest that for SFL: (1) when the data is viewed in the aggregate, these factors have a tendency to offset; (2) it is reasonable to project non-catastrophe losses and premiums using a 0% "net trend;"[76] and, (3) Staff's loss ratio method for projecting pure premiums was a valid alternative method for determining whether their initial pure premium projections were reasonable.

On the matter of the proper treatment of deductible shifts, there was conflicting testimony both between and *within* Staff and SFL's experts. SFL's Kelley testified that his 0% frequency trend projections assumed no further deductible shifts. Kelley's projections also assumed that decreases in frequencies over the historical period were solely due to changes in deductibles. SFL's expert Miller testified

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[73] Miller testified that although he used the method, but that it was also essential to look at frequency and severity separately. SFL Ex. 29 at 14.

[74] 2 Tr. at 62-67.

[75] 5 Tr. at 193-194. Crawshaw points to SFL Exhibit 27, page 61. Although Crawshaw pointed to the row labeled "Non-cat Loss and LAE," this pattern can also be seen in the row labeled "Non-Cat Loss."

that the change in SFL's deductible over the period of 1998-2002 would only cause a very small decrease in frequency and a very small increase in severity. One SFL witness appears to be arguing the large historic decreases in frequency[77] were solely due to changing deductibles, and the other SFL witness appears to be arguing that SFL's deductible shifts would cause only a small decrease in frequency.[78] Staff's testimony also contained internal contradictions. On the one hand, Crawshaw criticized SFL for assuming that decreases in claim frequency were solely due to deductible changes, but on the other, he used claim frequency as a proxy for the deductible in his separate frequency/severity analysis. For this reason, and because it is not clear that deductibles have been changing enough to give rise to a negative correlation between frequency and severity, the Commissioner rejects Crawshaw's separate frequency/severity analysis. In order to sort out the conflicting testimony, it is useful to look at two different cases: (1) deductibles shifts had a significant impact on claim frequency trends such that projecting frequencies at 0% is reasonable; and (2) deductible shifts had little impact on claim frequency trends.

*Case 1*

If deductibles had a significant impact on claim frequency trends, then deductibles have also had a significant impact on claim severity trends. SFL testified that it projected severity based on its historic level of increase. Since the historic severity trends contain an "extra kicker" due to changes in deductibles, SFL projected this trend into the future. Thus, SFL's projections treat the

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[76] "Net trend" in simple terms refers to the ratio of the loss trend to the premium trend. If the net trend is 0%, then losses and premiums are expected to change at the same rate.

[77] In fact, SFL's Miller criticized staff for projecting these large historic frequency decreases into the future. SFL Ex. 31 at 16.

[78] *Supra* Miller testimony, fn. 64.

deductible effect on frequency and severity inconsistently. The Commissioner does not accept SFL's argument that it considered the effect of the "extra kicker" by not selecting as high a trend as it could. The testimony is clear that SFL projected its severity trends based on the historic data and in *Case 1* that data contained this extra kicker.

SFL is correct that there would be an offsetting premium decrease in *Case 1* and SFL's premium projections assumed no deductible changes. In this case, a loss ratio approach would consider the offsetting effects on premiums and losses of changes in the deductible. Since Staff verified their pure premium projections using a loss ratio methodology, this effect was considered in Staff's pure premium projections.

*Case 2*

If deductible shifts had little impact on claim frequency trends, then deductible shifts had little impact on claim severity trends, and little impact on premium trends. In this case it is reasonable for SFL to project severity using historical trends, but it is also assuming that whatever factors are affecting claim frequencies will not continue into the future. As SFL testified, there are many factors that affect claim frequency in addition to the deductible, and in *Case 2* deductible changes had little impact on claim frequency. Therefore, SFL is assuming the effect of all these factors which decreased claim frequency in the past will stop. While SFL is correct that it makes no sense to project these decreases *ad infinitum*, it provided no evidence that these trends will not continue in the near term other than the statement that "they cannot continue forever." Staff's projections implicitly assume that whatever factors affected claim frequencies in the past will continue to affect claim frequencies in the future.

Since there is no evidence to the contrary, this is a more reasonable assumption than the assumption that from here on out these past factors will stop affecting claim frequency.

In examining both cases, the Commissioner finds that Staff's assumptions used to project its non-catastrophe loss provision are more reasonable than the assumptions SFL used to project its non-catastrophe loss provision.

SFL and Staff agree that when deductibles are changing, it may give rise to a negative correlation between frequency and severity. These parties also agree there is no inherent negative correlation between frequency and severity. Since there is conflicting evidence about the effect of deductibles, it is not clear whether any correlations observed in SFL's data can be expected to continue in the future. The Commissioner rejects Staff's argument that SFL's frequency/severity projections were flawed because they ignored correlations in the data. Rather the Commissioner finds that the assumptions SFL used to project its frequencies and severities were not reasonable.

In 2003, when Crawshaw reviewed the reasonableness of SFL's non-catastrophe loss projections, he reviewed the loss projections in the context of the entire filing, including the relationship between the losses and the premiums. In his analysis he compared SFL's June 26, 2003, filing to the analysis he had performed on SFL's rates a few months earlier. It is reasonable for Crawshaw to believe that the ratio of projected losses to projected premiums should not change significantly over a short period of time. The comparison he performed was based on erroneous premium data submitted by SFL in June 2003. If the erroneous premiums are higher than the correct premiums, reasonability checks that use the relationship between premiums and losses can make it appear that

the ratio of projected non-catastrophe losses to projected premiums had not changed significantly and lead to the erroneous conclusion that the projected non-catastrophe losses may be reasonable. When the same reasonability check is performed using *correct* premium data, it is perfectly acceptable for Crawshaw to change his opinion about the reasonability of the non-catastrophe loss projections since he initially had concerns they *may* have been overstated. He changed his opinion based on data that had changed; this was not arbitrary.

In developing Staff's projected losses for the OEC peril, Crawshaw only gave partial weight to the 2002 data. SFL's OEC severities from the period of 1996 to late 2001 varied between $800 per claim and $1,300 per claim. For the year 2002, these severities increased to over $3,000 per claim.[79] Since 2002 corresponds to a period where there were significant mold losses no longer covered under SFL's basic policy form, this fact raises the question whether SFL was, despite reasonable efforts, able to completely remove mold losses for 2002. Due to this uncertainty, it is reasonable to only give partial weight to SFL's 2002 OEC losses. It was reasonable for Staff to only give ⅔ weight to their pure premium projections including data for 2002, and ⅓ weight to their projections excluding data for 2002.

OPIC's witness did not analyze the data separately by peril, rather he analyzed the data on an all perils combined basis. He did not make any adjustments for losses that could be expected to be eliminated due to the approval of SFL's building loss settlement endorsement. All else being equal, an analysis separately by peril is preferable to an analysis of all perils combined. The projected pure premiums should contemplate the coverage that will be provided

[79] The corresponding pure premiums ranged from about $30 to $50 over the period 1996 to late 2001 and increased to over $120 at the end of 2002.

during the period in which the rates are being made; therefore it is necessary to adjust the losses to contemplate SFL's building loss settlement form. The non-catastrophe loss provision proposed by Staff is more reasonable than the non-catastrophe loss provision proposed by OPIC.

All parties testified that the non-catastrophe loss adjustment expense provision should be calculated by multiplying the non-catastrophe loss provision by a factor of 0.2675. Staff's provision for non-catastrophe loss and LAE is the more reasonable, and SFL's provision for non-catastrophe loss and LAE is unreasonably high. It is reasonable to include in the rates a provision for non-catastrophe losses and their associated claims adjusting expenses of $300.10 as recommended by Staff.

*C. Non-Hurricane Catastrophe Loss and Loss Adjustment Expense (LAE)*

State Farm Lloyds' Testimony

The purpose of a non-hurricane catastrophe loss and LAE provision is to account for losses, and their adjusting expenses, due to catastrophe events, excluding hurricanes. Catastrophe events are large and fortuitous occurrences that cause widespread property damage; they are unpredictable and are almost always weather-related. A good example of a *non-hurricane* catastrophe is a large hailstorm in a major metropolitan area. In developing its provision for non-hurricane catastrophe loss and LAE, SFL analyzed over 20 years of actual Texas homeowners data and related those losses to "amount of insurance year" or "AIY." AIY measures thousands of dollars of insurance coverage in force for one year. For example, a house insured for $150,000 continuously over a one-year period would represent 150 AIY.[80] The losses per AIY were adjusted to reflect

[80] *See* SFL Ex. 26 at 39-40.

the upward trend in SFL's catastrophe ratios. Finally, in order to provide stability, the annual change in the non-hurricane loss and LAE provision was capped at +/-10% compared to the prior year's provision.[81] The final result of SFL's calculations was a non-hurricane catastrophe loss and LAE provision of $244.14 per policy.

Staff's Testimony

Staff reviewed SFL's methodology and found it to be reasonable and adopted SFL's non-hurricane catastrophe loss and LAE provision of $244.14 per policy.[82]

OPIC's Testimony

OPIC used a non-hurricane catastrophe loss and LAE provision of $237.03.[83] In determining this provision, OPIC did not include an adjustment to reflect any upward trend in SFL's catastrophe ratios.[84]

Analysis

Based on evidence provided by SFL[85] and accepted by Staff, it is clear that SFL's non-hurricane catastrophe loss and LAE ratios have consistently trended upwards over the past 20 years. Therefore, it is reasonable to include an adjustment to account for this upward trend. Based on the above discussion, SFL's non-hurricane catastrophe loss and LAE provision of $244.14 per policy is reasonable.

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[81] SFL Ex. 26 at 40.

[82] TDI Ex. 69 at TDI 4243.

[83] OPIC Ex. 1 at 29.

[84] *Id*. at 15.

[85] SFL Ex. 26 at 200.

*D. Hurricane Catastrophe Loss and Loss Adjustment Expense (LAE)*

State Farm Lloyds' Testimony

Hurricane catastrophe loss and LAE provisions account for losses and their adjusting expenses due to hurricanes, which though infrequent, can generate a large number of claims and huge losses. Since hurricanes are potentially solvency-threatening events whose frequency and large variation in severity make them difficult to recognize in projecting future costs for ratemaking purposes, SFL decided to separate hurricane losses from non-hurricane losses in their analysis of catastrophes.[86] This is a generally accepted actuarial approach when determining the provision for catastrophe loss and LAE.[87] Similar to the non-hurricane catastrophe loss and LAE provision, SFL calculated the hurricane loss and LAE provision by first relating expected hurricane losses to AIY. SFL then translated the expected hurricane loss per AIY to an average dollar amount per policy.

SFL used computer hurricane simulation models to determine these expected losses. This is appropriate, one SFL witness explained, because the historical record is insufficient to calculate a provision in the rates for hurricane losses. Hurricanes are more infrequent compared to non-hurricane catastrophe events, resulting in a fairly small number of actual observations from which to determine expected annual hurricane losses.[88] SFL explained that:

> A [hurricane] computer simulation model is basically a series of algorithms that are executed to simulate the wind field generated by a hurricane event and calculates the associated property damage at various

[86] SFL Ex. 26 at 39.

[87] *Id*.

[88] *Id*. at 41-42.

> locations and the resulting insured loss. These models are quite involved and require a great deal of computing power. The modelers utilize a variety of professionals including meteorologists, wind engineers, structural engineers, statisticians, mathematicians, actuaries, and computer programmers to develop these models to assist the industry in measuring their hurricane exposure . . . . The computer simulation models allow a full range of possible hurricane events to be reviewed along the coastline, each with associated probabilities, to which various sampling techniques are applied. In essence, sampling from this library of hurricane events is equivalent to tens of thousands of simulated years of possible hurricanes.

SFL Ex. 26 at 42.

SFL used two different hurricane computer simulation models: EQECAT's USWIND™; and Risk Management Solutions, Inc.'s (RMS) RiskLink™.[89] In calculating its hurricane loss provision, SFL gave equal weight to each model. Since neither model calculated loss adjustment expense, SFL adjusted each model's results to include this cost.[90] It used a factor of 1.070.[91] The result of these calculations was a hurricane loss and LAE provision of $68.30 per policy.[92]

Staff's Testimony

Crawshaw reviewed SFL's methodology and concluded that the process SFL used was reasonable and the results were in line with his expectations based on his experience with reviewing other Texas homeowner filings.[93] He calculated a hurricane loss and LAE provision virtually identical to SFL's number: $68.31 per policy.[94]

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[89] *Id*. at 43.

[90] *Id*. at 44.

[91] The formula would appear as: 1.070 x MHL / AIY = $68.30, where MHL is Model Hurricane Losses.

[92] In addition to the hurricane loss and LAE provision, SFL included a "Hurricane Risk Provision" of 1.4% of premium. The analysis of this charge is discussed *infra* at Subsection G, "Reinsurance Costs."

[93] TDI Ex. 69 at TDI 4243.

[94] *Id*. at TDI 4279.

OPIC's Testimony

Schwartz reduced SFL's hurricane loss and LAE provision because he believed it included a 1.1254 factor for loss adjustment expense, rather than the 1.070 advanced by SFL. SFL's witness, Kelley, explained that SFL had made typographical errors in their June 26, 2003, rate filing.[95] These typographical errors gave the impression that a loss adjustment expense factor of 1.1254 was used rather than a factor of 1.070. Schwartz testified he would not object to SFL's hurricane LAE if they, in fact, used a factor of 1.070 rather than 1.1254.[96]

Analysis

There is no evidence in the record to suggest the errors discussed by Kelley were anything but typographical. Therefore, the Commissioner has no reason to doubt that SFL used a factor of 1.070 for hurricane LAE rather than a factor of 1.1254. Based on the above discussion it is reasonable to include a hurricane loss and LAE provision of $68.30 per policy.

*E. Fixed Expenses*

State Farm Lloyds' Testimony

The provision for fixed expenses captures operating expenses that do not vary directly with premium and therefore are calculated using a constant dollar amount per policy.[97] According to Kelley's testimony, SFL reviewed past fixed

[95] SFL Ex. 26 at 10.

[96] 5 Tr. at 162-163.

[97] Conversely, a "variable expense provision," as its name implies, is calculated on the basis of a percentage of premium.

expenses per policy, noting there was a significant increase in the fixed expense dollars per policy in 2002 (see following table ).[98]

| Calendar Year | Fixed Expenses Per Policy |
|---|---|
| 1998 | $83.57 |
| 1999 | $88.65 |
| 2000 | $85.69 |
| 2001 | $79.08 |
| 2002 | $110.98 |

In explaining the large increase in fixed expenses in 2002, Kelley testified that the two most significant drivers were: (1) a growing level of the liability for active and terminated agent termination payments; and (2) increased expenses for information technology.[99] He attributed two causes to the increase in agent termination liabilities: (1) an increase in rate levels which affected commission level, upon which termination payments are based; and (2) a reduction in the discount rate used to calculate the present value of future termination payments.[100] He explained the increase in expenses for information technology was due to a change in the method of determining these expenses.[101] Kelley also testified that "[e]xperts in other State Farm departments with responsibility for

[98] Table taken from SFL Exhibit 26, p. 124.

[99] SFL Ex. 26 at 57.

[100] *Id.*

determining and recording the liability for agent termination payments led us to expect additional increases in these expenses in 2003."[102]

Although conceding that the fixed expense data is subject to some level of volatility,[103] Kelley nonetheless concluded that the fixed expense levels during 2002 were indicative of the expected level for the review period to some degree, [104] and therefore, fixed expenses were most appropriately projected using 2002 results. Kelley calculated his fixed expense provision by projecting the 2002 results at a rate of 3% per year,[105] resulting in a fixed expense of $118.34.

Staff's Testimony

Crawshaw used a fixed expense provision of $90 per policy which, he explained, "discounts the 2002 experience."[106] He testified that the substantial increase from 2001 to 2002 in this category primarily was due to a change in the discount rate used in calculating the liability for agent termination payments which he believed would be non-recurring.[107] Crawshaw did, however, accept SFL's 3% growth projection of future expenses.

OPIC's Testimony

In his pre-filed testimony, Schwartz used a fixed expense provision of $107.83. He arrived at this number by "fitting a line" to SFL's fixed expenses for 1998-

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[101] *Id.*

[102] SFL Ex. 27 at 24-25.

[103] SFL Ex. 26 at 61.

[104] *Id.* at 56.

[105] *Id.*

[106] TDI Ex. 69 at TDI 4228-4229.

[107] 4 Tr. at 141-143. In his 2003 testimony, Crawshaw also questioned whether these expenses were reasonably allocated to Texas. He did not renew this objection in the instant proceeding.

2002 and projecting it forward to the average date the rates were expected to be in effect.[108]

Analysis

Both Staff and SFL referenced and cited the CAS Ratemaking principle that "[a] rate is an estimate of the expected value of future costs."[109] The principle holds that only costs expected to be incurred in the future should be considered in the rate; past costs are not considered, except to the extent they have predictive value in determining future costs. Ultimately, the dispute between Staff and SFL comes down to the question of whether SFL's 2002 fixed expenses are indicative of future costs. In their attempts to answer this question, both Staff and SFL were overwhelmed by the temptation to use, and in fact offered, data that was not available to the parties in September 2003.[110] For the reasons already stated, the Commissioner will not consider this hindsight testing evidence.

It is clear from the evidence that *at least some* of the costs included in SFL's 2002 fixed expenses can be expected to occur in the future ("prospective"). Crawshaw did not dispute that increased expenses due to information technology were "prospective" in nature. It is also clear from the record that *at least some* of the expenses incurred in 2002 are *not* expected to reoccur ("retrospective"). Both Staff and SFL agree that part of the increase in SFL's expenses from 2001 to 2002 was due to an increase in liabilities for agent termination payments. These two parties also agree that part of the increase was the result of a decrease in the discount rate used to evaluate those liabilities. The Commissioner finds

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[108] "Fitting a line" is a mathematical procedure that finds the "curve of best fit" for a series of data points. This curve or "line" minimizes the sum of the squared distance between the line and the data points.

[109] TDI Ex. 69 at TDI 4207 and SFL Ex. 26 at 5.

[110] Crawshaw referenced SFL's fixed expense data for 2003, 2004 and 2005. *See also* TDI Ex. 69 at TDI 4255. Kelley referenced SFL's fixed expense data for 2006-2007. *See also* SFL Ex. 27 at 27.

Crawshaw's testimony regarding the "one-time" effect of changes in the discount rate to be persuasive. The fact that this testimony was not rebutted by any SFL witness makes it even more so. Rather than rebut Crawshaw's testimony on this issue, SFL chose to rely on hearsay; "experts" at State Farm led them to expect such costs would increase in the future.[111]

Since the increase in SFL's 2002 fixed expenses included some expenses that are prospective in nature, it would be unreasonable to completely dismiss SFL's 2002 fixed expenses, as Crawshaw did. Accordingly, Crawshaw's $90 fixed expense provision is unreasonably low. Because the increase in SFL's 2002 fixed expenses included some expenses that are retrospective in nature, it would be unreasonable to solely rely on SFL's 2002 fixed expenses, as Kelley did. SFL's $118.34 fixed expense provision is unreasonably high.

A more appropriate method to determine SFL's fixed expenses is one that considers SFL's 2002 fixed expense data, but does not overly rely on it. Under this approach, multiple years of data are considered in order to smooth the volatility of fixed expenses. In his testimony Crawshaw calculated, for comparison purposes, a fixed expense provision using three years of data. While this methodology considers SFL's 2002 fixed expense data, it does not solely rely upon it. Crawshaw's methodology first projected SFL's fixed expenses for each of the years 2000-2002 assuming a 3% inflation rate, a rate supported by Kelley. The projected amounts for these three years were then averaged. The result of these calculations is a fixed expense provision of $100.34[112] which given the record, is the most reasonable.

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[111] *See*, fn. 102.

[112] TDI Ex. 69 at TDI 4255.

*F. Variable Expense Provision*

The purpose of the variable expense provision is to account for expenses that vary directly with premium. All parties treated agents' commissions and state premium taxes, licenses and fees ("taxes, licenses and fees") as variable expenses. SFL determined its projected commission expenses based on the ratio of actual commissions to written premiums in the calendar year 2002.[113] SFL also determined its projected taxes, licenses and fees based on the ratio of taxes to written premium for the historical period 2000-2002.[114] The result was a provision for variable expenses of 15.4% of premium. Staff accepted SFL's calculation as reasonable and OPIC used a slightly higher variable expense provision of 15.7% after a review of SFL's variable expenses for the calendar years 1998-2002.[115] The differences between Staff, SFL and OPIC are minor and since both Staff and SFL recommended a variable expense provision of 15.4%, it is reasonable to use a variable expense provision of 15.4%.

*G. Reinsurance Costs*

State Farm Lloyds' Testimony

Just as homeowners purchase insurance to help protect against catastrophic losses, insurers purchase a form of insurance termed "reinsurance" to protect the company's surplus from these same kinds of losses. Actuarial Standard of Practice (ASOP) No. 29 "Expense Provisions in Property/Casualty Insurance Ratemaking" provides that actuaries may consider a provision for reinsurance in the rates. If such a provision is included, the actuary should consider amounts to

[113] SFL Ex. 26 at 56. Also, SFL Ex. 26 at 172.

[114] *Id.*

[115] TDI Ex. 69 at TDI 4246 and OPIC Ex. 1 at 16.

be paid to the reinsurer (i.e., reinsurance premiums), commissions received by the reinsured, expected amounts the reinsured will recover under the reinsurance contract, and other relevant information relating to cost.[116]

SFL witness Jeffrey McCarty testified that there were two types of reinsurance at issue in this proceeding: stop loss reinsurance and catastrophe reinsurance.[117] Stop loss reinsurance is a type of reinsurance whereby the reinsurer agrees to reimburse the reinsured the amount of loss in excess of a defined threshold over the policy period, typically one year.[118] Catastrophe reinsurance provides protection against the reinsured's losses exceeding a certain dollar threshold due to a single event, such as a hurricane.

Effective January 1, 2002, State Farm Mutual Automobile Insurance Company (SFMAIC), an affiliate, reinsured SFL under a stop loss reinsurance contract which covered SFL's losses and expenses exceeding 130% of SFL's net earned premium within a calendar year, subject to a $200 million annual limit.[119] For this coverage, SFL paid SFMAIC 2.5% of its premium.[120] One SFL witness, Kelley, testified that, based on its initial assessment, SFL did not expect any recoveries under the reinsurance contract and included "zero" for expected reinsurance recoveries in their June 26, 2003, rate filing. SFL later amended its provision for stop loss reinsurance to include reinsurance recoveries of 0.6%, giving a net cost of reinsurance under the stop loss reinsurance contract of 1.9% (2.5% - 0.6%).[121]

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[116] SFL Ex. 26 at 54.

[117] SFL Ex. 36 at 5.

[118] *Id.*

[119] SFL Ex. 26 at 53.

[120] *Id.*

[121] *Id.*

SFL also included a Hurricane Risk Provision of 1.4% of its premium to account for the additional uncertainty associated with the risk of hurricanes. This was calculated by comparing the variance of modeled hurricane losses in Texas versus "company wide."[122] Kelley testified that the Hurricane Risk Provision included a net cost of catastrophe reinsurance of 1.2% of SFL's premium. The remainder of the Hurricane Risk Provision, i.e., 0.2% of premium, was a "retained risk provision."[123] The retained risk provision, Kelley testified, is a charge to compensate SFL for the additional risk arising from the hurricane exposure.[124]

Staff's Testimony

Crawshaw testified that his understanding was the net cost of reinsurance under SFL's "Stop Loss" and "Catastrophe" reinsurance contracts were 1.9% and 1.4%, respectively. Crawshaw testified that he used these estimates in his rate analysis.[125]

OPIC's Testimony

Schwartz objected to inclusion of the "Stop Loss" reinsurance cost of 2.5% and the Hurricane Risk Provision of 1.4%. Schwartz gave three reasons for objecting: (1) ratemaking is done on a direct basis, not on a net basis after reinsurance; (2) the expected loss recoveries were not reflected in the cost of reinsurance; and (3) the reinsurance is provided by SFMAIC and any profits on the reinsurance

[122] In this context, "company wide" appears to refer to the State Farm organization as a whole, rather than to State Farm Lloyds. *See also* SFL Ex. 26 at 120-121.

[123] SFL Ex. 26 at 49.

[124] *Id.* at 46.

[125] TDI Ex. 69 at TDI 4245.

agreement stay within the control of the State Farm group.[126] Schwartz objected to SFL's Hurricane Risk provision on the basis that he considered it "superfluous" and an "additional unneeded profit provision."[127]

Analysis, The Stop Loss Contract

The Commissioner rejects OPIC's argument that ratemaking must be done on a "direct basis" and not "net of reinsurance." When pressed, Schwartz admitted that actuarial principals provide for ratemaking on a net basis.[128] ASOP No. 29 is clear that it is reasonable to include a provision in the rates for the net cost of reinsurance. OPIC is correct to point out that the net cost of reinsurance for the "Stop Loss" contract must include an offset for the recoveries SFL is expected to receive. This is also consistent with ASOP No. 29. Even SFL's own witness, Miller, testified that it would raise serious questions about whether this contract is really reinsurance if the expected recoveries were "zero."[129]

OPIC's objection that the cost of reinsurance should not be included because the reinsurer is an affiliate company might have merit if there were any evidence that the premiums SFMAIC charged SFL were above market rates, but the record simply will not support such a finding. There is no evidence that the rate charged was uncompetitive or that the reinsurance premium included an "additional profit" to SFMAIC.

Since SFL amended its "Stop Loss" reinsurance provision to include an offset for expected reinsurance recoveries, OPIC's remaining objection to including these expenses is moot. In this regard, the record reflects that Schwartz did not

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[126] OPIC Ex. 1 at 13.

[127] *Id.* at 14.

[128] 5 Tr. at 180.

dispute the amount SFL included for expected reinsurance recoveries.[130] Based on the record, it is reasonable to include a provision of 1.9% for the cost of SFL's "Stop Loss" reinsurance contract.

Analysis, Hurricane Catastrophe Risk Provision

It is clear based on the testimony of Kelley that the "Hurricane Risk Provision" includes a provision of 1.2% of premium for the net cost of reinsurance for SFL's catastrophe reinsurance contract. There is no evidence in the record that SFL's 1.2% provision for the net cost of reinsurance was anything other than what SFL represented it to be. Therefore, at least 1.2% of the 1.4% provision is *not* an "unneeded profit provision" as first suggested by OPIC, but rather a cost to SFL for catastrophe reinsurance coverage. While OPIC did not verify or review the calculation of the 1.2%, neither did it dispute the value.[131] Crawshaw was mistaken that the 1.4% was for the net cost of reinsurance. It is plain from Kelley's testimony that 1.2% of the 1.4% was for the net cost of reinsurance and the remainder, 0.2%, was a "retained risk provision." The Commissioner agrees with SFL that it is reasonable to include a 1.2% provision in the rates for the net cost of SFL's catastrophe reinsurance treaty. The Commissioner does not dispute that SFL faces additional risk due to its hurricane exposure, but is of the opinion this exposure is best addressed in determining SFL's underwriting profit and contingencies provision.[132]

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[129] SFL Ex. 29 at 20.

[130] 5 Tr. at 181.

[131] *Id.* at 183.

[132] *See infra* p. 72.

*H. Contingency Load*

State Farm Lloyds' Testimony

SFL included in its rates a 2% contingency provision. Kelley testified that the purpose of the contingency provision was to account for systematic bias (or systematic variation) between the average actual results and the average expected results. He testified that a contingency provision is a legitimate consideration in the Ratemaking Principles and the Actuarial Standards of Practice (ASOPs).[133] The contingency provision, Kelley stated, is not expected to be realized as profit, but will be consumed by unforeseen losses and expenses. He provided examples of systematic variation, identifying such things as: unanticipated broadenings of coverage by the courts; actions (or inactions) by regulators; adverse court decisions or legislative changes; and uncertainty about whether, when, and how an insurer can obtain approval and implement any new rate in Texas given the new rating laws and the actions that TDI has taken.[134] Kelley testified that State Farm Fire and Casualty had an average annual underwriting loss, after adjusting for catastrophes, of -6.4% over the period 1991-2002.[135] Kelley also referenced an exhibit provided to TDI in July 2003, that showed over the period 1988-2002 SFL had an average underwriting loss, before adjusting for catastrophes, of -22.1%.[136] Another SFL witness, Miller, testified that SFL could have supported a contingency provision of 5%.

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[133] SFL Ex. 26 at 75.

[134] *Id.* at 78-79.

[135] SFL Ex. 6, page marked "Exhibit 7A."

[136] TDI Ex. 41 at TDI 3200.

Staff's Testimony

Crawshaw initially rejected SFL's contingency provision as not adequately supported. Crawshaw had three basic objections to SFL's support for its contingency load. First, he argued that the profit provisions SFL stated it included in its rates could not be verified since prior to 2003 SFL never filed its rates in Texas. Second, he objected that SFL's actual underwriting losses are not an appropriate measure of whether SFL's rate indications are biased. He argued that underwriting losses may be due to SFL implementing rates that are less than what was actuarially indicated. Finally, he argued that SFL's method for determining rate indications has likely changed over the years, and even if those methods were biased, that does not mean SFL's current ratemaking method is biased.[137] In its rebuttal testimony, SFL offered additional evidence showing a pattern of significant shortfalls between expected results and actual results based on filings in 46 states other than Texas. The additional evidence was based on rates actually implemented, rather than rate indications which were developed earlier in the ratemaking process, before selection of a different rate for approval and, ultimately, implementation.[138] In Crawshaw's oral testimony, he changed his opinion regarding SFL's contingency load, stating the additional evidence was "better than we've seen before."[139] He then testified he would no longer argue about the contingency load.[140]

[137] TDI Ex. 69 at TDI 4236.

[138] SFL Ex. 27 at 62-82.

[139] 3 Tr. at 168.

[140] *Id.*

OPIC's Testimony

Schwartz also objected to SFL's contingency provision. In his pre-filed direct testimony, he argued that contingencies are already reflected in the profit provision and a contingency load was an additional profit load for SFL.[141] In his oral testimony, Schwartz brought up several points about the contingency provision. First, he argued that there must be a systematic variation and SFL failed to show one. Schwartz cited the fact that during the period of 1996-2007 SFL made a profit in four years and had an underwriting loss in eight years.[142] Second, Schwartz testified that a contingency provision is only appropriate where there is a systematic bias that cannot be eliminated as part of the ratemaking process, and policy provisions and policy forms are part of the ratemaking process. He argued that when determining if a contingency provision is appropriate, one needs to consider changes to policy forms and policy provisions and determine if these changes have eliminated any indicated shortfall.[143] Third, he testified that trending can overcome some potential sources of systematic variation described by SFL. He argued that if there were persistent adverse court decisions against insurance companies, this would increase losses and these increases in losses would be projected in the future as part of the trending process, thus eliminating the need for a contingency provision.[144]

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[141] OPIC Ex. 1 at 14.

[142] 5 Tr. at 49.

[143] *Id.*

[144] 5 Tr. at 52-55.

Kelley responded to Schwartz's "trending" argument, testifying that if Schwartz were correct that trending eliminated shortfalls, then the data would not show a pattern of shortfalls, which it did.[145]

Analysis

Staff, OPIC, and SFL referenced Actuarial Standard of Practice (ASOP) No. 30, which defines a contingency provision as: "A provision for the expected difference, if any, between the estimated costs and the average actual costs that cannot be eliminated by changes in other components of the ratemaking process." While the Commissioner finds SFL's rebuttal testimony regarding OPIC's "trend" argument persuasive, OPIC's witness raised other legitimate questions about the relevance or reliability of the SFL contingency provision analyses in this case. It is not apparent to what extent changes in ratemaking procedures occurring either during the years analyzed or in subsequent years may have eliminated the cause of shortfalls. While it is clear based on the evidence that SFL experienced shortfalls, it is not at all apparent these shortfalls are due to biases in SFL's ratemaking methodology. Similarly, it is not evident whether, as Schwartz argues, these shortfalls were already addressed by changes in policy forms and policy provisions, especially as they relate to mold damage. SFL did not provide evidence of a link between the shortfalls and the ratemaking process. For example, it did not provide any evidence that would eliminate other possible explanations, such as how competitive pressures may have influenced the application of rating classifications, and thus, the premiums actually charged policyholders.

[145] 5 Tr. at 227.

The evidence does not support a finding that there *is* a systematic variation between expected costs and actual costs that cannot be eliminated by changes in other components of the ratemaking process. Inclusion of a specific 2.0% contingency provision *in the ratemaking formula* is inappropriate. However, the evidence does support a finding that there *may be* a systematic variation between expected costs and actual costs. Such a finding implies risk, and this risk can be considered in deriving an appropriate underwriting profit and contingencies provision.

*I. Provision for Surplus Note*

Background

Of all the contested issues in this case, none is more vexing and difficult than the proper treatment to be accorded to the Second Consolidated Surplus Debenture (surplus note). And unlike many issues dividing the parties where differences are more of degree than kind, the divide on the matter of the surplus note is fundamental and irreconcilable. SFL is adamant that a *separate* provision amounting to 9% of premium should be included in the rate indication in order to capture the costs of amortization (principal and interest) of the surplus note. Staff and OPIC are equally vigorous in opposing the inclusion of these amounts, asserting that the surplus note proceeds are capital and that "costs of capital" are reflected and accounted for in the provision for underwriting profit of 5%.

The surplus note arose out of SFL's dire need for a cash infusion after having suffered heavy losses due to hail and mold claims incurred during 2001-2002. SFL asserted that without this cash infusion it would have been statutorily insolvent,[146] a claim that neither Staff nor OPIC disputed.

[146] SFL Ex. 34 at 5-6.

State Farm Mutual Automobile Insurance Company ("SFMAIC"), an affiliate, advanced funds totaling $1.05 billion to SFL in three separate installments between November 15, 2001, and September 30, 2002.[147] These transactions formed the consideration for the subordinated surplus note issued by SFL to SFMAIC. A subordinated surplus note or debenture is a financial instrument that has the characteristics of both debt and equity. It is a "loan" that can be reported as "surplus,"[148] as opposed to debt, as long as it meets the requirements of statutory accounting regarding subordination and recording.[149]

The form and substance of the surplus note were approved by TDI under Commissioner's Order #02-1021.[150] The note calls for interest at the rate of 7% per annum, payable semi-annually, but only out of surplus that exceeds $700 million. Outstanding principal is payable only from the portion of SFL's surplus, if any, that exceeds $900 million. The surplus note matures on December 31, 2016, at which time the remaining balance of principal becomes due and payable, provided that SFL's surplus exceeds $900 million.[151]

State Farm Lloyds' Testimony

SFL's June 26, 2003, rate filing included a 9.0% of premium provision to reflect the costs – both principal and interest – associated with subordinated surplus

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[147] *Id*. at 11.

[148] "Surplus" refers to statutory surplus. Statutory surplus is similar to "net equity" under Generally Accepted Accounting Principles (GAAP), except statutory surplus is "net equity" (assets minus liabilities) determined under the accounting rules ("Statutory Accounting Principles" or "SAP") applicable to insurance companies for the purposes of reporting financial statements to TDI and other state insurance regulatory authorities.

[149] SFL Ex. 34 at 10.

[150] *See* SFL Ex. 34 at 24-25 for a copy of the Order.

[151] SFL Ex. 34 at 11.

debentures. SFL arrived at this figure by determining the annual cost of the surplus note, both principal and interest, using an amortization schedule.[152]

The company advanced several closely related arguments in support of including a separate cost provision that captures the amortization of the surplus note: (1) the surplus note represents an expense, not a cost of capital; (2) ASOP No. 29, *Expense Provision in Property/ Casualty Insurance Ratemaking* permits these outlays to be recognized as "start-up costs;" (3) the cost of the surplus notes is a cost to SFL to take on the risk of writing homeowners insurance; (4) without the additional capital provided by the surplus note, SFL would have become insolvent; (5) the repayment of the notes is, from an "economic perspective,"[153] the obligation of SFL's policyholders and therefore properly included in the rate; (6) since TDI approved the surplus notes, it is obligated to allow rates that permit SFL to timely pay back the surplus note with interest; (7) a rate, absent a separate provision for amortization of the surplus note is confiscatory; and (8) regulatory refusal to separately recognize these costs will jeopardize SFL's access to capital and send a message to the marketplace that surplus notes are an unacceptable method of accessing capital.

SFL argued through the testimony of Kelley that the costs of surplus note represent an expense and not a cost of capital, because the note was essential to SFL's continued existence. He testified that because the note supports the solvency of SFL, current customers benefit.

SFL advanced the point through the testimony of several witnesses that ASOP No. 29 permits the cost of the note to be considered as an expense. Kelley argued

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[152] SFL Ex. 26 at 65.

[153] Appel clarified he was not claiming that the policyholders had any legal obligation to repay the notes, but was referring simply to the underlying economics of the issue. SFL Ex. 37 at 9, fn. 8.

that the surplus note represents a "start-up" cost, and that start-up costs are permitted to be amortized under ASOP No. 29. Miller and William Hagar testified that Crawshaw's interpretation of ASOP No. 29 was overly restrictive, with Miller also testifying that the CAS Ratemaking principles were intended to include *all* costs associated with risk transfer.

Kelley testified that the notes were a cost to take on the risk of writing homeowners insurance. He argued that without the infusion of cash represented by the notes, it is reasonable to conclude that SFL would not be in business today.[154]

Echoing Kelley's testimony, Appel maintained that without the notes, SFL would have become insolvent. Therefore, the repayment of the surplus notes was, from an "economic perspective," the obligation of SFL's policyholders. He also argued that staff was treating the notes as if they were a "normal" investment in an insurance company, which he claimed they are not. "Normal" investments, he testified, are original contributions of capital, but the notes were a capital contribution in order to maintain solvency, and such contributions were "far beyond the norm."[155] Miller testified that since there was no economic reason for SFMAIC to provide additional capital contributions, the only source of capital for SFL was through its policyholders and the only way for policyholders to contribute capital was through the rates.[156]

Hagar opined that since TDI approved the notes, TDI was obligated "to allow rates that permit State Farm Lloyds to timely pay back the surplus notes with interest." He claimed that it was insufficient for TDI to approve rates that

[154] SFL Ex. 26 at 66.

[155] SFL Ex. 37 at 14.

[156] SFL Ex. 29 at 26.

"might," "could," or "would" result in timely payment "if by chance the market had a string of unusually good years and unusually good luck."[157]

According to Appel, the 5% profit provision – without a separate provision for the note – would produce confiscatory rates because SFL would only earn a 4% return on its surplus. In contrast, he testified, if SFL invested its surplus in stocks and bonds, it could earn a 6% return. This situation was confiscatory, because the return SFL could expect if it bore insurance risk (4%) was less than the return SFL could expect without bearing any insurance risk (6%).[158] In a similar vein, Miller testified that without a separate provision for the surplus note, the 5% profit provision "has to serve a lot of masters." Those included: the IRS, which takes 35% of the 5% profit, leaving a 3.3% profit; the need to compensate SFL for the hurricane risk it faces in Texas; and the need for SFL to repay the notes and rebuild its surplus. He concluded the 5% profit was insufficient to serve all of these "masters."

Hagar argued that if TDI prohibited rates "inclusive of the ability to repay the surplus note," then SFL's access to future capital would be greatly threatened. He added that if TDI prohibited recognition of the surplus note in SFL's rates, it would send a message to the marketplace that surplus notes are an unacceptable method of accessing capital. This, in Hagar's opinion, would create a "public policy fiasco."[159]

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[157] SFL Ex. 32 at 11.

[158] 3 Tr. at 85.

[159] SFL Ex. 33 at 7.

Staff's and OPIC's Testimony

Both Staff and OPIC objected to including a separate 9% provision in the rates for the repayment of the surplus notes. Staff's Crawshaw testified that the surplus note simply is a mechanism for SFL to acquire capital. In this regard, he pointed out that the proceeds of the surplus notes were included as "capital" when SFL performed its cost of capital analysis (and determined its underwriting profit provision).[160] He further contended that the costs of the surplus note were not "losses,"[161] and that under ASOP No. 29, the provision in the rates for expenses includes only those operational and administrative expenses associated with risk transfer which would exclude repayment of principal or interest.[162] Payment of these items should come out of the return that SFL is expected to make from its underwriting profit, investment income, and other income. He observed that in this situation, SFL is similar to any other firm that issues stocks and bonds[163] to obtain capital. Once obtained, a firm then invests that capital and expects to make a return commensurate with the risks involved. From the return it earns on its capital, it pays interest and principle to its bondholders, dividends to its stockholders, and retains the remaining profits.[164] He explained that even though the cost of the surplus notes is 9% of premium, and the underwriting profit provision is only 5% of premium, SFL would be able to amortize the surplus note from the 5% profit provision since it is expected to earn interest

[160] TDI Ex. 69 at TDI 4231.

[161] In this context, "losses" refers to claim payments.

[162] TDI Ex. 69 at TDI 4232-4233.

[163] Crawshaw stated "in this case SFL has sold bonds – i.e., surplus notes – to SFM[AIC] . . . ." TDI Ex. 69 at TDI 4234.

[164] TDI Ex. 69 at TDI 4234.

income of 7.5% to 10% of premium for a total return of between 12.5% to 15% of premium in pre-tax income.[165]

OPIC's expert, Schwartz, cited two reasons for disallowing a separate provision for the surplus note: the note represented an investment in SFL and any return on that investment should come from SFL's normal operating profits; and since the source of capital represented by the surplus notes was provided by SFMAIC, any profits from the surplus notes remain within the State Farm group of companies.[166]

Parties' Rejoinder

In response to Crawshaw's testimony, Appel countered that, even assuming Crawshaw's rate indications were correct, with a 5% underwriting profit provision it would take more than 20 years for SFL to amortize the surplus note and grow its surplus to a level where the ratio of premiums to surplus is 1:1. In his opinion, this was too long for the largest homeowners insurer in Texas to "suffer a lack of adequate capital."[167] He also testified that Crawshaw never demonstrated precisely how SFL could pay back the surplus note with a 5% profit provision and dismissed Crawshaw's claim as mere assertion.[168]

In his rebuttal testimony, SFL's witness, Kelley, pointed out that Crawshaw acknowledged that the "unusual circumstances" of the surplus notes provide "possible reasons to, basically, override the actuarial approach."[169]

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[165] *Id*. at TDI 4235.

[166] OPIC Ex. 1 at 14.

[167] SFL Ex. 38 at 4.

[168] SFL Ex. 39 at 6.

[169] SFL Ex. 27 at 34.

SFL witness Miller, testified he had "significant input"[170] into the drafting of ASOP No. 29 and it should not be interpreted in a way that would exclude legitimate business costs. He also stated he was "the sole author of the first working draft of the CAS Ratemaking Principles"[171] and the "lead author"[172] on subsequent drafts, and the intent of the CAS Ratemaking Principles was to include all costs associated with a risk transfer.

SFL's witness, Hagar, testified that Crawshaw's interpretation of the ASOP No. 29 was overly narrow, citing as Kelley did in his pre-filed testimony, the introduction to the ASOP's which states the ASOP's "are not narrowly prescriptive."[173] Hagar also testified that Texas law "trumps" Crawshaw's "narrow interpretation" of actuarial principals and that Article 5.142 permits and obligates the Commissioner to consider the surplus notes when determining SFL's rates. [174]

As a riposte to Appel's testimony that a 5% profit provision without a 9% provision to repay the surplus note was "confiscatory," Crawshaw testified that Appel's argument contained a "fallacy."[175] In Crawshaw's opinion, Appel was erroneously comparing the return SFL would receive on its surplus *after* amortizing the cost of the surplus note (4%) with a theoretical return SFL could receive *before* deducting these costs (6%). Crawshaw also pointed out that according to Appel's own calculations, SFL could expect to receive a 24% return

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[170] SFL Ex. 30 at 21.

[171] *Id*. at 20-21.

[172] *Id*. at 21.

[173] SFL Ex. 33 at 4.

[174] *Id*. at 5.

[175] 3 Tr. at 164-166.

on its surplus *before* deducting the costs of the surplus note and assuming a 5% profit provision with no separate provision for the surplus note.

Crawshaw noted that if SFL did, in fact, invest its surplus in a low-risk investment that earned 6%, it would nonetheless remain obligated to make principal and interest payments on the note as scheduled. He illustrated his point by using the example of a rental house acquired through a mortgage. The fair rate of return for owning the house is determined by the gross rent. From the rental proceeds, the owner makes interest and principal payments on the mortgage. What the owner is left with *after* making mortgage payments will be less than the return earned by the gross rent. He concluded that the answer to the question of whether SFL can be expected to receive a fair rate of return is determined using the return *before* "you do all these capital and financing activities,"[176] not afterwards. In other words, the "rental income," or the return expected before deducting the cost of the surplus note is what is used to determine whether SFL is earning a fair rate of return.

OPIC's expert, Schwartz, stated that even if you look at the surplus note from an accounting standpoint, there is no basis for including a separate provision in the rates. Schwartz explained that principal payments are not an expense, and interest payments are not an underwriting expense for accounting purposes.[177] Finally, Schwartz argued that the inclusion of a separate provision for repaying the surplus notes would require the policyholder to capitalize SFL without the benefits of ownership. In his oral testimony he stated:

> Essentially State Farm's proposal is saying that they want policyholders to pay for capitalizing State Farm Lloyds. State Farm Lloyds is saying

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[176] *Id.*

[177] 5 Tr. at 62.

> they want policyholders to essentially contribute a billion, 50 million to State Farm Lloyds. They want policyholders to put that capital into the company, but at the end of the day after the policyholders put all that capital into the company, the policyholders don't own any of the company.
>
> So allowing a separate provision for the surplus notes effectively forces policyholders to capitalize the company, contribute to the surplus of the company, but not have any ownership interest in the company, and that – that doesn't make any sense. If policyholders in Texas are going to be forced to contribute over a billion dollars to capitalize the company, then they should own the company. Not – not still just be policyholders of the company with no ownership interest.

5 Tr. at 63.

Analysis

To pass constitutional and statutory muster a rate must allow for a reasonable rate of return. It was precisely because article 5.26-1's "inadequate" proof provision could only guarantee a break-even return and not a reasonable return that the Court of Appeals struck it down.[178] Rate regulated companies, including insurers, are constitutionally entitled to something more than the mere recovery of their operating expenses. A rate must permit an insurer "reasonable returns on its investments sufficient to assure confidence in the continued financial integrity of the enterprise."[179] "[T]he return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks." *FPC v. Hope Natural Gas*, 320 U.S. 591, 603 (1944).

Capital can be acquired through debt, equity, or both. A rate must assure an enterprise enough revenue to cover the capital costs of the business which

[178] *Geeslin* at 795.

[179] *Geeslin* at 795, citing *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 307 (1989).

include service on the debt and dividends on the stock.[180] Capital costs, also known as "opportunity costs," historically have been accounted for in the ratemaking box known as "underwriting profit." Both Staff and OPIC contend that the 5% underwriting profit provision they put forth in their respective rate proposals already assures SFL a reasonable return on its invested capital. SFL disputes this and wants a heretofore unknown separate ratemaking box to reflect the costs of amortizing the surplus debenture. It also wants 9% of premium placed in the box. It advances a number of arguments, none of which the Commissioner finds persuasive for the reasons more fully set out below, to justify why it needs insureds to pay a surcharge amounting to an extra 9% of premium.

What SFL seeks by insisting on a separate provision for the surplus note is a rate which will produce something far more than a reasonable return on its capital; it seeks nothing less than a rate which, in effect, would require its policyholders to provide new capital to replenish capital previously lost. And it was anything but opaque on this point. Appel articulated very well what SFL was after:

> [T]he first thing to consider is whether the rates as proposed by State Farm Lloyds or the rates as proposed by TDI at the time were sufficient to both cover the expected future losses and expenses associated with the exposures State Farm was writing as well as to provide an adequate return on capital *and a path to restore the capital to an adequate level*. (emphasis added)

5 Tr. at 300.

He then noted that "absent consideration of a path to restore the capital to an adequate level, that any consideration about the appropriate rate would have

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[180] *FPC v. Hope Natural Gas*, 320 U.S. at 603.

been incomplete."[181] SFL's Miller made the same point: "The only reasonable alternative for SF Lloyds' with its financial track record was a provision in the rates to begin to rebuild necessary capital."[182]

A rate that provides a reasonable return and also bears the extra burden of supplying fresh capital is one that is neither constitutionally nor statutorily required. Nor is such a rate legally permissible under the facts of this case because it is excessive.

While it is understandable, from a financial perspective, why SFL seeks to advance its self-interests through such a special provision, it is important to note that SFL's financial interest is only one of several that the Commissioner is constitutionally and statutorily required to consider. Policyholders and the public interest also have a "seat" at the ratemaking table and those interests, together with SFL's, must be appraised and balanced.

It should be noted that while a regulated entity is constitutionally entitled to a return sufficient to attract capital and ensure its continued financial viability, it has no constitutional claim to any particular rate of return above a rate which achieves these ends. As Justice White observed in *FPC v. Texaco*:

> Rate regulation unavoidably limits profits as well as income. 'The fixing of prices, like other applications of the police power, may reduce the value of the property which is being regulated. But the fact that the value is reduced does not mean that the regulation is invalid.' *FPC v. Hope Natural Gas Co.* All that is protected against, in a constitutional sense, is that the rates fixed by the Commission be higher than a confiscatory level. *FPC v. Natural Gas Pipeline Co.* (citations omitted)

*FPC v. Texaco*, 417 U.S. 380, 391-392 (1974).

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[181] 5 Tr. at 300.

[182] SFL Ex. 29 at 26.

Above the confiscatory level, "[r]egulation may . . . limit stringently the return recovered on investment, for investors' interests provide only one of the variables in the constitutional calculus of reasonableness." *Permian Basin Area Rate Cases*, 390 U.S. 747, 769 (1968). "[T]he fixing of 'just and reasonable' rates, involve a balancing of the investor and consumer interests." *FPC v. Hope Natural Gas*, 320 U.S. at 603. In an old fire rate case, the Austin Court of Appeals similarly observed that an 'equitable' rate[183] as required by the statute means a rate that is "reasonable, alike to the insurer and the insured . . . ." *American Alliance Ins. Co. v. Board of Insurance Commissioners*, 126 S.W.2d 741, 744 (Tex. Civ. App.-Austin 1939, writ ref'd.). The Court went on to note that:

> Clearly a duty both to the insuring public and the insurance carriers is imposed by the statute. And this duty necessarily implies that the Board shall take into consideration every factor essential to the promulgation of a rate which shall be as low to the insured as is consistent with a reasonable return to the insurer.

*Id*.

The Commissioner finds that the inclusion of a separate surplus note provision, in addition to rate provisions that already contemplate SFL's expected future costs, including its cost of capital "is likely to produce a long term profit that is unreasonably high in relation to the insurance coverage provided."[184]

SFL insists, however, that any rate determined without a 9% provision for the repayment of the surplus note, would be confiscatory. The claim deserves close scrutiny. To reach such a result one would have to accept the methodology for

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[183] While none of the statutes setting out rate standards applicable to this case use the word "equitable," they do deploy the synonyms "just" and or "fair." In the context of this or any other rate proceeding the statutory goal is to render a rate that is "fair, just and equitable" among the competing interests of insurers, insureds and the public.

[184] TEX. INS. CODE art. 5.142 (2)(b)(1) and TEX. INS. CODE ANN. § 560.002 (c)(2) (Vernon 2009).

calculating a rate of return advanced by Appel. For the reasons articulated by Crawshaw, the Commissioner finds that methodology unsupportable.

Appel testified the return produced if SFL invested its surplus in a theoretical investment of low-risk securities is expected to be 6%. This return is greater than the 4% return SFL is expected to earn by writing insurance policies, after deducting for the costs of SFL's surplus notes. Therefore, according to Appel, any rate providing a 5% underwriting profit under the facts of this case, without the special surplus provision, is confiscatory.

Crawshaw effectively rebutted this argument by making two separate points. First, he noted that if SFL had invested its surplus at 6%, they would still be obligated to make payments on the surplus note. The 4% return quoted by Appel is after deducting for payments SFL is obligated to make on the surplus note, whereas if SFL decided to stop writing business and invest its surplus in low risk securities, the 6% return does not take into account the fact that SFL must still make those surplus note payments. Thus, the 4% and the 6% are not comparable. This point was not challenged or rebutted by Appel in his oral response testimony.

Second, Crawshaw testified the proper return to use when determining whether a return is fair is the return expected on the company's capital prior to deducting the costs of debt financing. This point also went unchallenged by Appel. As first articulated by the United States Supreme Court in *FPC v. Hope Natural Gas*, and reaffirmed many times, for regulated entities, "the return to the equity owner should be commensurate with the returns on investments in other enterprises having corresponding risks." [185] The fair return *for the investment* is determined

[185] *FPC v. Hope Natural Gas*, 320 U.S. at 603.

by the risk of the enterprise, not the manner in which the investor acquired the funds used to invest in that enterprise. The fair return the investor should realize *from that investment* is independent of whether the investor borrowed the funds to invest in the enterprise (i.e., issued debt to invest) or whether the investor used its own funds to invest in the enterprise. Using Crawshaw's analogy of a rental property, the rent a landlord can receive for renting his property is determined by the market; it is not what the landlord thinks is ideal. A landlord who borrows money to buy a given property does not receive a higher rent than a landlord who purchases the same property with his own funds.

Similarly, in answering the question of whether SFL is provided a fair return, we must examine the return SFL can expect by investing its capital by engaging in the business of homeowners insurance in Texas. This is independent of how SFL acquired that capital. In other words, the correct return to examine is *the return SFL can expect to earn prior to the cost of debt financing*.

This return, as calculated by Appel, was 24% of SFL's actual surplus.[186] The testimony of Staff and SFL is that a 5% underwriting profit provision is at least minimally sufficient to provide "service on the debt" and modest growth in SFL's surplus.[187] In fact, the 4% quoted by Appel is the amount by which SFL's surplus is expected to grow after it has made payment on the surplus note. Appel objected to the 5% underwriting profit, not on the basis that it did not provide enough to amortize the surplus note and grow SFL's surplus. Rather, he objected because it could be expected to take 20 years for SFL to completely pay off the surplus note and grow its surplus to a 1:1 premium to surplus ratio. He

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[186] While this return seems high to a casual observer, it is important to note that this return reflects the very high risk associated with SFL writing, in 2003 $2.8 of premium for each $1 of surplus. *See* 3 Tr. at 36.

[187] Growth in SFL's surplus can be thought of as "dividends on the stock" except this growth is not paid as dividends, but reinvested in the enterprise.

believed 20 years was an unreasonably long period of time. The Commissioner finds nothing in the law that would require him to establish a rate so an insurer can expect to grow its surplus to a pre-determined level over a specified period of time, over and above its cost of capital.

The Commissioner also rejects SFL's argument that the surplus note and related interest are an expense. Clearly, the surplus note is capital. ASOP No. 30 defines capital as "[t]he funds intended to assure payment of obligations from insurance contracts, over and above those backing liabilities."[188] SFL's witness, Gregory Clapper, testified the note may be counted as surplus; and surplus is generally defined to be assets less liabilities. Indeed, the only reason SFL issued the surplus note was to provide SFL with much-needed capital. Since the note is capital, it follows that interest on the debt is a cost of acquiring that capital. This is also consistent with *FPC v. Hope Natural Gas*, which makes clear that capital costs include "service on the debt."[189] In addition, the notes are clearly not "start-up costs." As SFL's own witnesses testified, the note at issue was a consolidation of notes issued in 2001 and 2002, and SFL has been writing homeowners insurance in Texas since at least 1996.

SFL's remaining arguments on this issue are also without merit. SFL argues the cost of the surplus note is a cost of SFL to take on the risk of writing homeowners insurance. This is true, but the cost of capital takes into account the risk of writing homeowners insurance. In other words, this cost is already taken into consideration in determining an appropriate underwriting profit for SFL. SFL also argues the repayment of the surplus note is an economic obligation of its policyholders; failure to provide a separate provision will jeopardize SFL's access

[188] SFL Ex. 17 at 1.

to capital; and TDI is obligated to provide a separate provision because it approved the terms of the surplus note. As discussed previously, the only obligation of policyholders and the Commissioner is to provide SFL a reasonable return on its capital, a return that is commensurate with the return earned on alternative investments of similar risk. If such a return is provided, then investors will have an incentive to provide capital to insurers. This cost of capital is contemplated when the underwriting profit provision is determined. SFL's final argument, that the notes were issued in order to stave off insolvency, will be discussed *infra*.

Under the established facts of this case, the Commissioner finds that including a separate 9% provision for the repayment of the surplus note in addition to rate provisions that already contemplate SFL's expected future costs, including its cost of capital, will result in excessive rates.

Despite this finding, the Commissioner also finds that SFL's situation in 2003 was dire. No witness disputed SFL's testimony that without a capital contribution from SFMAIC, SFL would have been in receivership. Significantly, Crawshaw admitted on cross-examination that in 2003 SFL's premium to surplus ratio was at least 2.35:1, compared to the statutory maximum of 3:1. In addition, the Commissioner recognizes the benefit derived when SFL repays the surplus note and grows its surplus to a level of capital necessary to support its writings. In this event, SFL will no longer be dependent upon SFMAIC for capital. If this objective is not achieved, and there is a future catastrophe, needed capital may not be forthcoming from SFMIAC and the resulting impact on both SFL policyholders and the homeowners insurance market in Texas would be severe.

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[189] *FPC v. Hope Natural Gas*, 320 U.S. at 603.

Therefore, the Commissioner finds it is reasonable to consider the existence of the surplus note, and SFL's obligation to repay it when determining: (1) the level of risk faced by SFL in writing homeowners insurance in 2003; (2) an appropriate premium to surplus ratio or cost of capital; and (3) an appropriate underwriting profit provision.

*J. Underwriting Profit and Contingencies Provision*

As fully set out above, insurers are entitled to a return on their invested capital that is commensurate with the risk involved in engaging in the business of insurance. However, underwriting profit does not provide the sole means of this return, but rather it is an item included in the rate calculus that closes the gap between the return they are earning on their investments and a reasonable return on their capital.

There are two basic approaches for determining the required return on capital. The first method uses an average amount of capital and adjusts the required return on that capital for risk; an above-average rate of return indicates above-average risk, and a below-average rate of return indicates below-average risk. The second method uses an average rate of return and adjusts the amount of capital required for risk; the amount of capital required is increased as the risk increases and vice versa.[190] The first method gives the insurer a risk-adjusted return on an average level of capital; whereas the second method gives the insurer an average return on a theoretical, risk-adjusted, level of capital. Both methods are widely accepted methods of determining the required return on capital, and ultimately, the underwriting profit provision.

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[190] This is commonly done by means of adjusting the leverage ratio, which is typically the ratio of premium to surplus. When surplus is increased, the leverage ratio decreases, so one can reflect above-average risk by lowering the premium to surplus ratio, and vice versa.

State Farm Lloyds' Testimony

SFL used the second method, and utilized a theoretical premium to surplus ratio of 1.0 to 1.0 in determining its underwriting profit provision of 5%. Due to severe underwriting losses, SFL's actual surplus in 2003 was much lower than that implied by a 1.0:1.0 premium to surplus ratio. SFL's profit model indicated that a 5% underwriting profit provision, a 1.4% "hurricane risk provision," and a 1.0:1.0 premium to surplus ratio, combined with its investment income, produced an after-tax return on surplus of 12.4%, and a "GAAP Adjusted Return"[191] of 9.6%. Through the testimony of Appel, SFL characterized the 9.6% GAAP adjusted return as "slightly conservative,"[192] if viewed as a return for a line of insurance that has "average risk."[193] Appel also testified that, in his opinion, an appropriate premium to surplus ratio for Texas homeowners "might well be less than 1.0:1.0, but certainly is not greater."[194] He cited three reasons for his opinion: (1) The premium to surplus ratio for homeowners, nationally, is about 1.1:1.0, a ratio that does not necessarily reflect the "unusually high risk"[195] insurers face in Texas; (2) the premium to surplus ratio for reinsurers writing property insurance is significantly lower than 1.0:1.0;[196] and (3) the results of his solvency model indicated an unacceptable probability of insolvency (4%) if SFL's actual premium to surplus ratio was used. In Appel's opinion, even considering

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[191] SFL Ex. 6, page titled "Exhibit 7," line 13. At least one SFL witness testified that SFL does not file financial statements on a GAAP basis. SFL Ex. 35 at 3. In the context of the exhibit, "GAAP adjusted-return" appears to be SFL's estimate of what the return would be if GAAP equity was used rather than statutory surplus.

[192] SFL Ex. 37 at 16.

[193] *Id.*

[194] SFL Ex. 37 at 20.

[195] Appel cited hurricane risk and a "wide variety of catastrophic losses" as reasons insurers faced unusually high risk in Texas. SFL Ex. 37 at 22.

reinsurance, SFL was still exposed to above average risk. Regarding the premium to surplus ratio, Appel concluded that "[i]n light of the fact that SFL is not charging anything in the rate for catastrophe reinsurance, premium to surplus ratios as low as 0.5 to 1.0 *could* be justified." (emphasis added)[197]

Staff's Testimony

Crawshaw also recommended a 5% underwriting profit provision, utilizing the same profit model used by SFL, but with a slightly greater expectation for investment income. Crawshaw's model indicated a 5% underwriting profit resulted in a 9.9% return on GAAP equity, which he deemed reasonable.

OPIC's Testimony

OPIC suggested a 2.5% profit provision based largely on consideration of a 1% profit provision previously used in a TDI benchmark rate decision, with judgmental adjustments for changes that occurred between the adoption of the 1% and the 2003 SFL rate filing.

Analysis

OPIC's 2.5% profit provision recommendation was not directly supported by any model relating the 2.5% profit to any particular return on GAAP equity. The Commissioner finds that, given the testimony of SFL and Staff recommending a higher profit provision, and OPIC's lack of support for the 2.5%, a 2.5% profit provision would be unreasonably low.

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[196] While Appel admitted that property reinsurers face more risk than direct property insurers, he opined that it was indicative of the capital required to support the highly risky portion of property insurance. *See* SFL EX. 37 at 23.

[197] SFL Ex. 37 at 23.

The small difference between SFL and Crawshaw regarding the expected investment income was adequately addressed by SFL through Kelley's pre-filed testimony. Therefore, SFL's profit model is the most appropriate model to use, but additional consideration of the inputs used in the model is appropriate.

The Commissioner finds the testimony of Appel convincing regarding an appropriate premium to surplus ratio for the purposes of determining the underwriting profit provision. The inclusion of an appropriate reinsurance provision in the rate greatly diminishes Appel's argument for a premium to surplus ratio as low as 0.5:1.0. However, Appel also brought forth the point that SFL faces elements of catastrophe exposure not fully contemplated by the reinsurance provision. The fact that SFL faces elements of risk not fully contemplated by the reinsurance provision offers some support for the use of a premium to surplus ratio of modestly less than 1.0:1.0. In addition, the justification for using a premium to surplus ratio of modestly less than 1.0:1.0 to determine the underwriting profit provision is strengthened when other elements of risk are considered. SFL is predominantly a single-state insurer that derives almost its entire premium from a catastrophe-prone line of insurance in a catastrophe-prone state. As noted in Section VI (I) *supra*, the existence of the surplus notes, and the obligation to repay principal and related interest, is an element of risk inherent in SFL's writing of homeowners insurance in 2003. The element of risk associated with repaying $1.05 billion in surplus notes by a date certain would not be present in a typical insurer. As noted in Section VI (H), *supra*, the conclusion that there *may be* systematic variation between expected costs and actual costs also implies risk. Given the existence of these factors, the Commissioner finds that it is reasonable to accord to SFL's writing of homeowners insurance in 2003 a greater measure of risk than is contemplated in

a 1.0:1.0 premium to surplus ratio. This finding is based on the conditions that existed for SFL in 2003. Some of these conditions, if not all of them, are temporary in nature. With this proviso, a reasonable premium to surplus ratio for use in this proceeding would be somewhere below 1.0:1.0, but well above 0.5:1.0. The profit provisions consistent with such a range of premium to surplus ratios are in the range of 7.0% to 10.0%. A reasonable profit and contingencies provision, including a provision for hurricane risk, for SFL in conjunction with its writing of homeowners insurance in Texas in 2003 is 8.5%.[198] This underwriting profit provision is appropriate for only as long as the conditions discussed above apply to SFL.

*K. Conclusions*

All parties essentially used the same methodology to calculate the overall rate change; only the inputs differed. The table below shows the overall rate change for each party, and the overall rate change indicated by the Commissioner's decision on each rating component already discussed in this section.

[198] This finding is confined to the evidence in this record. It should not be inferred that this profit provision would be appropriate in any other case.

| | Rate Provision | SFL | Staff | OPIC | Commissioner |
|---|---|---|---|---|---|
| (1) | Projected Earned Premium | $1,041.74 | $1,041.59 | $1,131.00 | $1,041.59 |
| | | | | | |
| (2) | Non-Catastrophe Loss and LAE | $332.45 | $300.10 | $339.13 | $300.10 |
| (3) | Non-Hurricane Catastrophe Loss and LAE | $244.14 | $244.14 | $237.03 | $244.14 |
| (4) | Hurricane Catastrophe Loss and LAE[199] | $84.89 | $68.31 | $64.94 | $68.30 |
| (5) | Fixed Expense | $118.34 | $90.00 | $107.83 | $100.34 |
| (6) | Subtotal – Loss, LAE, fixed Expense [(2)+(3)+(4)+(5)] | $779.82 | $702.55 | $748.93 | $712.88 |
| | | | | | |
| (7) | Variable Expense | 15.4% | 15.4% | 15.7% | 15.4% |
| (8) | Surplus Note | 9.0% | 0.0% | 0.0% | 0.0% |
| (9) | Net Cost of Reinsurance – Catastrophe Treaty | Included in (4) | 1.4% | 0.0% | 1.2% |
| (10) | Net Cost of Reinsurance – Stop Loss Treaty | 1.9% | 1.9% | 0.0% | 1.9% |
| (11) | Underwriting Profit and Contingencies Provision | 7.0% | 7.0% | 2.5% | 8.5% |
| (12) | Subtotal – Variable rate provision [(7)+(8)+(9)+(10)+(11)] | 33.3% | 25.7% | 18.2% | 27.0% |
| | | | | | |
| (13) | Indicated Premium [(6) / {1.0 - (12)}] | $1,169.15 | $945.56 | $915.56 | $976.55 |
| (14) | Indicated Rate Change [(13) / (1) – 1.0] | +12.3% | -9.2% | -19.0% | -6.2% |

## VII. THE RATE TO BE CHARGED FOR SUBSEQUENT PERIODS

### *A. Determining a Rating Methodology for the Subsequent Period*

Having decided the duration of the subsequent period, we now face the difficult and uncharted task of adopting a rating methodology to determine what the appropriate rate for the period should be.

State Farm Lloyds' Testimony

Kelley testified that he developed two actuarially appropriate methods, both prospective in nature, to determine the rate after September 1, 2004. [200] His first method uses only information known or knowable at the time SFL prepared its June 2003 rate filing. He testified the necessary ratemaking components can be projected for the entire multi-year period based on one set of data (i.e., data known or knowable as of September 2003). Ratemaking components would be determined by extending projections used to originally develop those ratemaking components. Kelley noted the method is easily accomplished mathematically, and it provides both a reasonable and reliable prospective ratemaking approach. For purposes of clarity, we will dub it the *Trend Projection Method*.

Under his second method, which we will call the *Augmented Data Method*, rates would be determined for subsequent periods by augmenting the historical data contained in the June 26, 2003, filing one piece at a time. For example, the rates for the period of September 1, 2004, through August 31, 2005, would be developed by augmenting the data available in the June 26, 2003, rate filing with

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[199] SFL's Hurricane Catastrophe loss and LAE includes a 1.2% of premium provision for its catastrophe reinsurance treaty and a 0.2% of premium "retained hurricane risk provision."

[200] SFL Ex. 26 at 97.

new data that became available between September 2003 and September 2004. Ratemaking components would be developed and projected based on the augmented data. Kelley testified that this method provides a more informed basis for projections since it is based on more recent information. He testified that it was possible this method could be influenced by one's personal knowledge of "issues and trends, etc. that have become known since June 2003,"[201] but emphasized this danger was minimized if SFL's previously developed projections were used. Kelley testified that both approaches were valid, reasonable, prospective actuarial methods, but he had a "slight preference" for the *Augmented Data Method*.[202]

Staff's expert, Crawshaw, testified he believed the indications offered by SFL in connection with the *Augmented Data Method* were excessive.

OPIC's witness, Schwartz, objected to SFL's *Trend Projection Method* for two reasons. He objected to SFL's starting point rate indication of +12.3%, stating the Commissioner had determined this rate change was excessive. Schwartz further objected because SFL assumed net trend will increase the rate indication, whereas he believed that net trends remain flat or decrease over time.

Schwartz also objected to SFL's *Augmented Data Method* arguing once again that the starting point indication of +12.3% was excessive, and for the further reason that SFL had incorporated assumptions based in its May 30, 2006, rate filling seeking a 9.1% rate increase which two ALJs found excessive.[203]

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[201] SFL Ex. 26 at 100.

[202] *Id*. at 104.

[203] SFL initially submitted a +20.8% rate increase; this was later amended to a +9.1% increase. *See* TDI Ex. 55 at TDI 3459.

Staff's Testimony

Crawshaw calculated rate indications only through July 1, 2006. He used a methodology that had as its starting point his rate indication for the initial period. As his ending point, he used the rate indication derived by two ALJs in their PFD when they considered SFL's May 30, 2006, rate filing.[204] With one exception, he calculated rate indications for intervening periods by interpolating the provisions that go into the rates[205]. For reinsurance costs, Crawshaw instead used the actual costs.

SFL's witnesses objected to Crawshaw's methodology. Kelley testified that there was no actuarial basis or support for his methodology and did not believe it satisfied the rate setting guidelines of the applicable statutes. Kelley pointed out that Crawshaw's "rate indications" were not rate indications, but rather "mere interpolations."[206] Kelley concluded that Crawshaw's methodology was not actuarially appropriate. Miller also objected to Crawshaw's methodology, testifying the only appropriate methodology was Kelley's Augmented Data Method, but also acknowledged that the Trend Projection Method could be used as a "short cut."[207]

OPIC's witness, Schwartz, objected to Crawshaw's methodology on two grounds. Schwartz stated "a +3.6% rate increase was not implemented in response to [the] PFD, and that in fact a +3.6% rate increase could not be implemented as a result of the PFD. Therefore, whatever rate was appropriate to

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[204] Specifically, Crawshaw considered that in SOAH Docket #454-06-3176.F the Hon. James W. Norman and the Hon. William G. Newchurch found in Conclusion of Law No. 30 that it would be reasonable for SFL to increase its rates by +3.6%. TDI Ex. 55 at TDI 3629.

[205] Crawshaw calculated rate indications for the periods: July 1, 2004, through June 30, 2005, and July 1, 2005, through June 30, 2006. TDI Ex. 69 at TDI 4261.

[206] SFL Ex. 27 at 46.

[207] SFL Ex. 29 at 9.

use prior to the PFD is also the appropriate rate to use after the PFD."[208] Schwartz also rejected Crawshaw's methodology on the basis that it was not prospective ratemaking.

Analysis

The remanded nature of this proceeding puts the Commissioner in a very difficult and unusual situation. The task is to determine an appropriate rate for a period much longer than was ever anticipated when this case was first heard in 2003. Indeed, formulating a homeowner's rate for such a long duration is simply unheard of. Adding to the difficulty is the fact that this case is unlike most every other rate case where rates are determined prospectively.

Even though the peculiar facts of this case drive adoption of a methodology that is rare, if not unknown, it is important, to the extent possible, to remain guided by and grounded in accepted actuarial standards and the prospective nature of insurance ratemaking. The Commissioner finds SFL's *Trend Projection Method*, given the facts of this case, to be the most suitable for determining the appropriate rate for the subsequent period.

For the reasons previously discussed, OPIC's method is unacceptable.

Crawshaw's method strays too far outside the "actuarial box." OPIC and SFL testified that his method was neither prospective (Schwartz), nor actuarially appropriate (Kelley & Miller). In addition, Crawshaw's method relies on the Norman/Newchurch PFD which the Commissioner has already found has no probative value in this case. Staff and OPIC both objected to SFL's *Augmented Data Method* on the basis that it relied on rate changes, and their corresponding inputs, which may be excessive.

[208] OPIC Ex. 2 at 3.

SFL's *Trend Projection Method* has the advantage in that it relies on SFL's June 26, 2003, rate filing, for which a record was fully developed. Kelley testified that it is both actuarially appropriate and prospective in nature. In addition, while Staff objected to the *Augmented Data Method*, it did not oppose the *Trend Projection Method*.

OPIC's objection that the *Trend Projection Method* uses a starting point rating indication of 12.3% is rendered moot, since as set out below, the starting point is the initial rate reduction. OPIC's other objection that net trends remain flat or decrease over time for catastrophe loss and LAE and fixed expenses finds no support in the record and is rejected. Also, Kelley's testimony that the *Augmented Data Method* was only "slightly preferred" further convinces the Commissioner that SFL's *Trend Projection Method* is most suitable for determining a rate for SFL for the subsequent period.

*B. Rate Calculation for the Subsequent Period*

To apply the *Trend Projection Method*, it is first necessary to determine a rate indication as the starting point from which to trend the appropriate ratemaking provisions. The most appropriate and logical starting point is the initial rate reduction determined in this order.

Next it is necessary to determine the trends which are applied to each of the applicable ratemaking provisions. While the Commissioner agrees with OPIC that it is reasonable to use 0% net trend for non-catastrophe loss and LAE, [209] the Commissioner does not find it reasonable to apply this assumption to the other

[209] *See supra,* "Analysis" in Subsection VI.B., "Non-Catastrophe Loss and Loss Adjustment Expense (LAE)."

trended provisions used in the ratemaking formula.[210] There is no evidence in the record to support a 0% net trend assumption for these *other* provisions. The most appropriate trend assumptions to use are those made and found in this record by the expert witnesses when they originally projected the ratemaking components. The annual trends set out in the record are as follows:

| **Rate Provision** | **Annual Trend Percentage** |
|---|---|
| Earned premiums | 1.30%[211] |
| Non-catastrophe loss and LAE | 1.30%[212] |
| Hurricane catastrophe loss and LAE | 1.80%[213] |
| Non-hurricane catastrophe loss and LAE | 4.85%[214] |
| Fixed expenses | 3.00%[215] |

[210] Specifically, the Commissioner refers to: (1) fixed expenses; (2) Non-Hurricane Catastrophe Loss and LAE; and (3) Hurricane Catastrophe Loss and LAE.

[211] Both SFL and Staff applied the same premium trend. The 1.30% value is shown on SFL Ex. 26, "Kelley Exhibit 2" at 113, Subsection I.B.

[212] Staff's non-catastrophe loss and LAE provision was found to be the most appropriate for determining the initial rate. *See supra* p. 34. Therefore, it is most appropriate to use Staff's Non-catastrophe loss and LAE trend to determine the rate for the subsequent period. *See* TDI Ex. 69 at 4266, note (d) for the 1.30% value.

[213] For determining the initial rates, the Commissioner adopted the Hurricane Catastrophe Loss and LAE provision used by both SFL and Staff. These parties calculated their hurricane catastrophe loss and LAE provision per unit coverage amount and the trend in coverage amount assumed is 1.8% per annum. *See* SFL Ex. 26, "Kelley Exhibit 2," page 113, Subsection I.B.

[214] *Id*. (1.8%) compounded with 3% in SFL Exhibit 26, "Kelley Exhibit 2," at 123. The calculation is as follows: [(1.0 + 1.8%) x (1.0 + 3.0%)] – 1.0 = 4.85%. The first value is necessary because, like the hurricane catastrophe loss and LAE provision, the parties calculated the non-hurricane catastrophe loss provision per unit of coverage amount, and the growth in coverage amount is 1.8%. The second value is the trend in the non-hurricane catastrophe losses per AIY, as discussed *supra* in Subsection VI.C.

[215] Both SFL and Staff used the same fixed expense trend. *See* TDI Ex. 69 at TDI 4255, note (b) and SFL Ex. 26 at 56 for the 3.0% value.

In their projections, these experts trended the provisions underlying their rate indications for the initial period by assuming the rates would be in effect from September 2003 to September 2004. Each party trended the loss, LAE and fixed expense ratemaking provisions to September 1, 2004.[216] This date corresponds to the average date of loss for policies with effective dates from September 2003 to September 2004.[217] The subsequent period is September 1, 2004, through July 31, 2008, and the average date of loss for the subsequent period is February 15, 2007.[218] Therefore, in order to determine the trended ratemaking components for the subsequent period, trend should be extended for an additional 29.5 months, or 2.46 years.[219] The results of these calculations are as follows:

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[216] SFL Ex. 29 at 7; SFL Ex. 26 at 114-116, 118; TDI Ex. 69 at TDI 4247; OPIC Ex.1 at 20-21, 32.

[217] SFL Ex. 31 at 10. The average date of loss for the period is the mid-point between the date the first policy became effective, and the date the last policy expired. This is common actuarial practice. *See, e.g.*, G. Werner and C. Modlin, Basic Ratemaking, page 112 (Casualty Actuarial Society, 2009). For the initial period, the first policy became effective in September 2003. The last policy issued in the initial period became effective in August 2004. Since each policy was issued for a term of one year, the date the last policy expired was August 2005. Therefore, the mid-point of the period from September 2003 to August 2005 is September 1, 2004.

[218] As set out in *fn*. 217 above, the average loss date is the mid-point between the date the first policy became effective and the date the last policy expires. For this period, the first policy becomes effective on September 1, 2004. The last policy became effective on July 31, 2008, and finally expires on July 31, 2009, a period of 59 months. The mid-point of the period is 29.5 months, or 2 years and 5.5 months from September 1, 2004. Two years and 5.5 months from September 1, 2004, is February 15, 2007.

[219] The method employed by the Commissioner is slightly different than that employed by Kelley. Kelley recommended the components be trended in annual segments. Hence, Kelley's method would apply the annual trends for each year. The Commissioner is trending the components for the entire time period as a whole, using the "average trend factor" applicable for the entire time period. Using annual segments, the trend factors would be: $(1+t)^1$, $(1+t)^2$, $(1+t)^3$, and $(1+t)^{3.96}$; whereas the Commissioner's method uses a factor of $(1+t)^{2.46}$, where t is the applicable annual trend percentage. The Commissioner's factor is essentially the geometric average of the factors that would apply using annual segments. There is no substantive difference in the total refund amount SFL would be required to pay using either Kelley's method or the method employed by the Commissioner. This is especially true in light of the testimony of Appel that SFL has "extremely high" renewal rates. *See* 5 Tr. at 317.

| Rate Provision | Trended Amount |
|---|---|
| Earned premiums | $1,075.22[220] |
| Non-catastrophe loss and LAE | $309.79[221] |
| Hurricane catastrophe loss and LAE | $71.36[222] |
| Non-hurricane catastrophe loss and LAE | $274.31[223] |
| Fixed expenses | $107.91[224] |

For determining SFL's rates for the period after September 1, 2004, the Commissioner finds the rate provisions as calculated above fully supported by the record and thereby adopts them for purposes of calculating a rate for the *Subsequent Period*.

In determining the initial rate reduction, no party trended variable expenses or reinsurance costs. Therefore, when determining SFL's rates after September 1, 2004, for these provisions it is reasonable to use the same values used to determine SFL's initial rates. These values are set forth in the table below.

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[220] $1,041.59 x $(1.013)^{2.46}$ = $1,075.22.

[221] $300.10 x $(1.013)^{2.46}$ = $309.79.

[222] $68.30 x $(1.018)^{2.46}$ = $71.36.

[223] $244.14 x $(1.0485)^{2.46}$ = $274.31.

[224] $100.34 x $(1.03)^{2.46}$ = $107.91.

| Rate Provision | Amount |
|---|---|
| Variable expenses | 15.4% |
| Reinsurance costs – catastrophe treaty | 1.2% |
| Reinsurance costs – stop loss treaty | 1.9% |

The Commissioner has found that an 8.5% underwriting profit provision is appropriate for the conditions that existed in 2003. One consideration for determining this underwriting profit provision is the need for SFL to repay the $1.05 billion surplus note by December 31, 2016. During the subsequent period, SFL made substantial payments of principal on the surplus note, reducing the overall principal due on the surplus note from $1.05 billion to approximately $852.3 million as of December 31, 2006, and $653.3 million as of December 31, 2007, which continued throughout 2008.[225] Thus, during the subsequent period, SFL repaid approximately $400 million in surplus note principle, or more than one-third of the outstanding principle.[226] This, in turn, reduces the risk associated with SFL's need to repay the $1.05 billion surplus note by December 31, 2016. The evidence of the reduced surplus note principal is tempered by the testimony provided by Appel and Miller that SFMAIC has little or no economic incentive to provide additional capital to SFL, given the historic losses SFL has suffered.[227] Therefore, in consideration of the preceding facts and testimony, the Commissioner finds it reasonable to use an underwriting profit and

[225] For the $852.3 million figure, *see* TDI Ex. 12 at TDI 793. For the $653.3 million figure, *see* TDI Ex. 11 at TDI 595. For 2008, *see also* TDI Ex. 8 at TDI 459, TDI Ex. 9 at TDI 498, TDI Ex. 10 at TDI 535, and TDI Ex. 78 at 3 (page marked SFL-08 007588).

[226] $1.05 billion less $653.3 million equals $396.7 million, which is 37.8% of $1.05 billion.

[227] Appel. SFL Ex. 37 at 15-16. Miller. SFL Ex. 29 at 26.

contingencies provision modestly lower than the 8.5% used to determine the rate during the initial period. The Commissioner finds it reasonable to use an underwriting profit and contingencies provision of 8.0% to determine the rates for the subsequent period.

The Commissioner finds that SFL's rates were excessive during the subsequent period, and a reduction in SFL's base rates of -3.4% will produce rates that are just and reasonable and neither excessive nor confiscatory for the risks to which they apply.[228]

## VIII. REFUNDS

### A. *Authority to Adjudicate*

SFL argues that the Commissioner lacks authority to adjudicate issues regarding refunds because article 5.26-1 is silent on the matter. According to its view of the new regulatory regime ushered in by SB 14, while the Commissioner has the authority to determine a rate in these proceedings, he is powerless to hear, let alone decide, any matter that touches on the issue of refunds should he find that a reduction from SFL's filed rate is otherwise required by the law and the facts of this case. It argues that the plain language of 5.26-1 can permit no other result because "[t]he portion of the statute that provides for refunds is contingent-it is not triggered until and unless a final rate reduction order is upheld on 'final appeal'."[229] Under SFL's construction, liability is adjudicated separately from damages; it is only until the liability issue is finally determined adversely to the insurer that the Commissioner has the authority to calculate and award damages, i.e., refunds.

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[228]Calculation of the -3.4% is found *infra* p. 130.

[229] SFL's Motion and Response to TDI's Motion Requesting Clarification and Reconsideration of Pre-Hearing Order No. 1 at 5.

But this argument conflates the issue of the authority of the Commissioner to adjudicate refunds with one dealing with who bears the risk of economic loss during an appeal of a rate order adverse to the insurer. One of the more contentious issues during the debate on S.B. 14 was what rate an insurer could charge on appeal: the rate it had filed or the reduced rate ordered by the Commissioner. This issue was of special concern to those insurers, like SFL, who were not previously subjected to rate regulation and who, unlike their rate regulated cousins, did not have the benefit of ever having a rate "vetted" by the Department.

The insurers ultimately prevailed on the point and were given the option under both articles 5.26-1 and 5.142 (the temporary prior approval regime) to either charge their filed rate or the reduced rate as determined by the commissioner during an appeal.[230] The language pointed to by SFL is not dispositive of the issue of whether the commissioner has the authority to adjudicate refunds. It merely operates to suspend the execution of the commissioner's order pending appeal without the necessity of filing an appeal bond. In the event the insurer fails to prevail in its appeal, insureds are protected because the losing insurer is required to refund the excessive premium *and* what in effect amounts to "post judgment interest."

Given the legislative history and the circumstances under which SB 14 was enacted,[231] it is simply unthinkable that the Legislature would deliberately

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[230] Significantly, insurers were not given this option under the permanent file and use system. Article 5.13-2, now codified at Section 2251 is silent on the matter. Appeals of Section 2251 rate reduction orders are subject to Insurance Code Sections 36.204 and 37.053 and can only be vacated or stayed if a district court finds that "it would serve the interest of justice to do so." TEX. INS. CODE ANN. § 36.204(b) (Vernon 2009).

[231] The Court of Appeals in *Geeslin* described the environment in which SB 14 was enacted: "From 1991 through 2003, Texas insurance companies operated under a system of flexible rate setting, which allowed insurers to charge up to 30 percent more or less than a state-promulgated benchmark rate. House Research Organization, Bill Analysis, Tex. S.B. 14, 78th Leg., R.S. (2003). During that time period, in an effort to avoid

construct a legislative scheme where complete relief to injured ratepayers could be delayed indefinitely because such relief could only be accomplished through two separate trials: one to establish liability and a subsequent one, years later, to calculate and award damages (refunds). Staff's characterization of SFL's construction is well taken and on point:

> A Commissioner's determination that rates are excessive, even if upheld on appeal, is meaningless if overcharged premiums are not returned to policyholders. Either State Farm Lloyds assumes that the amount of refunds will be self-evident, or it expects refunds to be adjudicated at a second hearing.

TDI's Motion Requesting Clarification and Reconsideration of Pre-Hearing Order No. 1 at 4.

As this record makes painfully clear, the calculation of policyholder refunds is anything but self-evident, straightforward or simple. SFL, while arguing that the Commissioner lacks jurisdiction to adjudicate refunds nonetheless was not shy to invoke it. Among other things, SFL asked the Commissioner to:

> — consider "the important facts of State Farm Lloyds' overall risks, obligations, operations, and long term financial condition;"
>
> — determine refunds on an aggregate basis;
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> — take into consideration periods of time where SFL's rates were inadequate and use this to offset any refunds due to policyholder for periods of time when SFL's rates were excessive;

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regulation, insurance companies began shifting more and more of their business toward unregulated branches called Lloyd's companies. *Id.* Originally unregulated because they generally covered specialty risks at lower-than-standard rates, Lloyd's companies grew from about 20 percent of the market in 1991 to about 95 percent of the market in 2003. *Id.* Thus, by 2003, only five percent of the Texas homeowners insurance market was regulated. *Id.*; House Comm. Report, Tex. S.B. 14, 78th Leg., R.S. (2003). In this mostly unregulated market, Texas consumers were paying the highest premiums in the country, often for policies providing reduced coverage. *Id.*

To address these issues, the Texas Legislature passed Senate Bill 14, which amended the insurance code to establish a new system for regulating residential property insurance rates." *Geeslin v. State Farm Lloyds*, 255 S.W.3d 786, 792. (Tex. App.-Austin 2008, no pet.).

> — allow SFL to pay refunds only to current SFL policyholders that were also insured during the period the Commissioner determined SFL had overcharged its customers;
>
> — calculate the refund due to individual policyholders based solely on the number of months the policyholder was insured during the period over which refunds were determined; and
>
> — allow SFL to provide a renewal credit in lieu of a cash refund.[232]

Under its construction of the statute and assuming for purposes of illustration that it loses on appeal, SFL would be free to calculate and pay refunds in the manner suggested above notwithstanding the fact that the Commissioner in this Order has rejected much of what SFL proposes to do. Without authority in *this* proceeding, the Commissioner could be forced, years from now, to initiate an enforcement action to establish the methodology of calculating refunds. Given the history of this case, a new record duplicative of the instant record would be established at SOAH with yet another appeal likely.

SFL, through the statutory construction it advances, seeks to achieve in effect what it was denied at the Court of Appeals, to wit: a reversal and *rendering* of the original appeal hearing since it is doubtful that under its construction complete relief for ratepayers could ever be achieved. Statutes are not to be construed in such a way that lead to absurd results[233] and therefore the Commissioner, given the circumstances under which SB 14 was enacted, the object it sought to attain and its legislative history, finds that he has the authority to adjudicate refunds.

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[232] SFL's Brief on Refund Issues at 2, 7.

[233] Assuming *arguendo* that the Article 5.26-1 language "if on final appeal the court upholds the commissioner's determination that the insurer's rates are excessive, the insurer shall refund" is unambiguous, courts nonetheless are precluded from applying the text if it would lead to absurd results. "If the statutory text is unambiguous, a court must adopt the interpretation supported by the statute's plain language unless that interpretation would lead to absurd results." *Texas Department of Protective & Regulatory Services v. Mega Child Care*, 145 S.W.3d 170, 177 (Tex. 2004).

Notwithstanding SFL's arguments to the contrary, it should be noted that article 5.26-1 is not the exclusive source of the Commissioner's authority to adjudicate issues regarding refunds.[234] Although not referenced by any party, Article 5.144 now codified as Insurance Code Chapter 2254, "Premium Refund for Certain Personal Lines," expressly gives the Commissioner such authority. The provision originated in Representative John Smithee's successful Amendment No. 1 to CSSB 14 and with minor changes carried over to the Conference Committee Report. In describing his amendment to his colleagues on the House floor, Smithee observed:

> It [Amendment No. 1] does also provide for refunds of any rates that are charged to a consumer *during the full course of this bill*, that are excessive and don't meet rate standards until those rates are approved by the department. (emphasis added)

Debate on Tex. C.S.S.B. 14 on the Floor of the House of Representatives, 78th Leg., R.S. (May 21, 2003, afternoon session. Official Internet Broadcast available at: http://www.house.state.tx.us/media/chamber/78.htm, 1:15:06-1:15:21).

True to Smithee's characterization, the text of Article 5.144 applies to *all* rates filed after June 11, 2003: "This section applies to a rate filed on or after the effective date of Chapter 206, Acts of the 78th Legislature, Regular Session, 2003." TEX. INS. CODE ANN. § 2254.003(a) (Vernon 2009). The grant of authority of the Commissioner to adjudicate refunds is equally clear:

> [I]f the commissioner determines that an insurer has *charged* a rate for personal automobile insurance or residential property insurance that is excessive . . . the commissioner may . . . order the insurer to refund directly to each affected policyholder the portion of the premium, plus interest on that amount, that is excessive . . . . (emphasis added)

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[234] "Nothing in the statute suggests or authorizes adjudication of refund amounts or premium overcharges in the administrative appeal hearing required by Article 5.26-1, § 4, which is for the sole purpose of adjudicating a disputed 'rate reduction.'" SFL's Motion and Response to TDI's Motion Requesting Clarification and Reconsideration of Pre-Hearing Order No. 1 at 5.

TEX. INS. CODE ANN. § 2254.003(b) (Vernon 2009).

SFL *filed* its "initial" rate on June 26, 2003, fifteen days after the effective date of SB 14 and the Commissioner in this Order determined that SFL has *charged* excessive rates. The application of Chapter 2254 to the facts of this case would be unassailable but for a textual conflict between 5.26-1 and 5.144 regarding the role of SOAH. The Legislature in seeking speedy resolution of "initial rate" filings under Article 5.26-1 directed that any appeal of a rate determination made by the Department proceed directly to the commissioner and thus by-pass SOAH: "Notwithstanding any other provision of this code or the Government Code, the hearing shall not be conducted by the State Office of Administrative Hearings, but directly by the commissioner."[235] Chapter 2254, on the other hand, provides an appeal to SOAH from a commissioner's order regarding refunds for rates charged and found to be excessive. Less consequential, but a conflict nonetheless, Article 5.144 as enacted made no provision for requiring an insurer to pay interest in the event of a losing appeal. A "post judgment interest" provision was added in the following session. It provided for a rate of interest substantially greater than that set out in 5.26-1: "the lesser of 18 percent or the sum of six percent and the prime rate for the calendar year in which the commissioner's order finding that the rate is excessive or unfairly discriminatory is issued."[236]

The amendment, SB 14,[237] was filed by Senator Mike Jackson. In the Author's/Sponsor's Statement of Intent, Senator Jackson pointed specifically to

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[235] TEX. INS. CODE art. 5.26-1 (4).

[236] TEX. INS. CODE ANN. § 2254.003(c) (Vernon 2009).

[237] Not to be confused with the original SB 14, 78th Legislature, Regular Session, 2003.

this litigation as support for increasing the interest rate payable to policyholders should an insurer fail to prevail on an appeal of a rate order:

> Despite the overall success of last session's S.B. 14, two insurance companies have effectively used Texas's court system to their advantage. One company is still in the court system disputing the Texas Department of Insurance's (TDI) initial rate adjustment and their customers (who represent thousands of Texas consumers) have yet to see the rate reductions they were promised last session.
>
> . . . S.B. 14 also amends Article 5.144, Insurance Code, to refund excessive or unfairly discriminatory premium at a rate of prime plus six percent on amounts that are more than 7.5 percent of the total premium charged for the coverage. If the excessive or unfairly discriminatory premium is less than 7.5 percent, the insurer is required to provide each affected policyholder a future premium discount in the amount of the overcharge at the prime rate plus six percent.
>
> S.B. 14 sets interest rates on unfair or discriminatory premiums in such a way to discourage companies from using the court system to gain a financial incentive. The goal of this legislation is to give the commissioner additional tools to return excessive and unfair premium payments to the policy holders as quickly as possible.

Senate Business & Commerce Committee, BILL ANALYSIS, Tex. S.B. 14, 79th Leg. , R. S. at 1 (2005).

Reading Articles 5.26-1 and 5.144 together and given the legislative history, including the 2005 amendment to article 5.144, it is manifest that the Legislature intended to vest with the commissioner complete authority to make injured policyholders whole, including the authority to adjudicate refunds.

At base, the conflict between Articles 5.26-1 and 5.144 is procedural. Article 5.144 is differentiated only by the fact that it provides an additional appellate step at SOAH. The Code Construction Act commands that, where possible, amendments shall be harmonized so that effect may be given to each.[238] Also, in discerning legislative intent, it is presumed that: (1) the entire statute is intended

[238] TEX. GOV'T CODE ANN. § 311.025 (Vernon 2009).

to be effective; (2) a just and reasonable result is intended; (3) a result feasible of execution is intended; and (4) public interest is favored over any private interest.[239]

Under the peculiar circumstances of this case, including the fact that when this matter is finally resolved, Article 5.26-1 will expire, the Commissioner has determined that he has authority under both articles. Interest on refunds due and owing shall be calculated at the Article 5.26-1 rate for the period beginning September 7, 2003, and continuing through the date of this Order and under the rate set out in Chapter 2254 of the Insurance Code for the period following the entry of this Order until paid. This interpretation gives effect to both articles.

SFL was fully apprised by Pre-Hearing Order No. 3 that evidence regarding refunds would be taken and considered, so it cannot be heard to complain that it lacked notice. In fact, SFL proffered considerable evidence regarding the calculation of refunds. The elimination of what would amount to a redundant rehearing at SOAH cannot be said to prejudice its rights in any way either. SFL was given the opportunity to develop and did develop a complete record on both the rate and refund issues.

B. *Off Sets*

SFL argues the Commissioner must recognize any "needed increase" in SFL's rates and use those amounts to offset any amounts SFL overcharged its customers.[240] This argument assumes, incorrectly, that at some point SFL's rates became inadequate. The Commissioner has found that SFL's rates were excessive for all periods at issue in this proceeding.

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[239] *Id*. § 311.021.

[240] *See*, *e.g.*, SFL's Brief on Refund Issues at 7.

*C. Accrual of Interest*

SFL takes the position that any refund interest due in the event of a failed appeal does not begin to accrue until the date of this Order. In support of this position, it advances three principal arguments. First, citing the fact that the original order in this proceeding was struck down as invalid and unconstitutional, it argues that there is no principal amount upon which interest can be calculated: "Consequently, no interest has been or could be accruing on an unknown and unquantifiable amount of principal. If the Commissioner makes a determination after this remand hearing that refunds are warranted, it is only *that* determination to which interest can apply."[241] It next raises the issue of fairness: "After having been subjected to an unconstitutional hearing and order by the former Commissioner of Insurance that denied State Farm due process, and an unconstitutional rate rollback statute passed by the legislature, as expressly determined only through a final judicial ruling after a lengthy appeal, it would be fundamentally unfair and further penalize State Farm Lloyds to impose interest back to 2003."[242] Finally, SFL argues that it would be "arbitrary and capricious" for the Commissioner to require it to pay interest dating back to 2003 in light of Article 5.26-1's silence on an accrual date and in view of the "facts, policy considerations, and equities of this remand proceeding."[243]

SFL cites no authority in support of its position that the invalidity of the prior Order relieves it of a statutorily imposed duty to pay interest on refunds dating back to 2003 and made due and owing by the terms of this Order.[244] While it is

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[241] SFL's Brief on Refund Issues at 17.

[242] *Id*. at 17-18.

[243] *Id*. at 18-19.

[244] If the parties were in federal court, such a result might obtain because under Federal Rule of Appellate Procedure No. 37 and the common law, post judgment interest begins to accrue from the second judgment

true that Article 5.26-1 does not specify an accrual date and Chapter 2254 commands that "[t]he period for the refund and interest begins on the date the department first provides the insurer with formal written notice that the insurers filed rate is excessive . . . and interest continues to accrue until the refund is paid"[245] could be subject to differing interpretation, the obvious intent of the legislature in the event refunds are ordered is to make the ratepayer whole. When viewed from this perspective, the interest component can be fairly compared to post-judgment interest and the underlying public policy that supports it. The Texas Supreme Court in explaining the policy stated: "Post-judgment interest is not a punishment inflicted on a judgment debtor for exercising the right to appeal. Instead, like pre-judgment interest, post-judgment interest is simply compensation for a judgment creditor's lost opportunity to invest the money awarded as damages at trial."[246]

The equities here properly can be claimed by the policyholders. If this refund Order is upheld on appeal; one salient fact stands out: SFL should not be able to use policyholders' money as it pleased for more than six years, and then pay nothing for its use. Therefore, in order to make policyholders whole by accounting for the time-value of money as the legislature intended, interest on refunds shall accrue as set out below.

On January 2, 2003, the prime rate was 4.25%. Therefore, interest accrues on the refunds ordered herein for the period beginning September 7, 2003, and continuing until November 12, 2009, at a rate of 5.25%. Interest shall be calculated using simple interest and shall be calculated for each of the policy

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where the first judgment lacked an evidentiary or legal basis. *See e.g., Cordero v. De Jesus-Mendez*, 922 F.2d 11, 16 (1st Cir. 1990) (interpreting Fed. R. App. P. 37). But this case is not governed by either federal or Texas rules of procedure; it is governed by the Insurance Code.

[245] TEX. INS. CODE ANN. § 2254.003(c) (Vernon 2009).

periods of: September 7, 2003, through August 31, 2004; September 1, 2004, through August 31, 2005; September 1, 2005, through August 31, 2006; September 1, 2006, through August 31, 2007; and September 1, 2007, through July 31, 2008, excluding new business written from June 1, 2008, through, July 31, 2008. Interest shall be determined based on the number of days from the mid-point of each period until November 15, 2009.

The prime rate on January 2, 2009, was 3.25%. Therefore, interest accrues at the rate of 9.25% for refunds remaining unpaid as of November 16, 2009, and continuing until paid.

D. *Financial Impact of Refund Order/Deferral/Credit on Renewal*

Having established that the Commissioner has the authority to adjudicate the issue of refunds and having further found that refunds are due and owing with interest calculated as set out above, we must now turn to the issue of what consideration, if any, the Commissioner should accord to the impact such an order will have on SFL's financial condition. Is it appropriate or even legally permissible to consider the financial impact of ordering refunds with respect to their calculation or method of payment?

Given their silence, neither Article 5.26-1 nor Article 5.144 is helpful in resolving the issue of calculation although Article 5.144 provides some payment options. For the reasons as more fully set out below, the Commissioner finds that while he has no authority to consider the financial impact of refunds with respect to their calculation, he has ample authority to consider the financial impact in determining the protocol under which they are to be paid.

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[246] *Miga v. Jensen*, 96 S.W.3d 207, 212 (Tex. 2002).

The impact of the refunds on SFL's financial condition is essentially a question of the impact on its surplus. From an accounting perspective, surplus is simply defined to be assets less liabilities. But this definition fails to account for the important role that surplus performs in the insurance context. The purpose of surplus is to provide a "cushion" for when actual losses and expenses turn out greater than expected.[247] For example, while SFL's rates contemplate average hail losses, it is not the case that every year SFL will have losses equal to that average. In some years the losses will be below average, and in other years the losses will be above average. A company's surplus is there to ensure that when actual losses exceed expected losses, policyholder claims will still be paid. What must be addressed here is whether SFL will be put in a hazardous financial condition as a result of refunding excess premium with interest as required by this Order.

SFL, through Hagar and Appel, testified that even if refunds were appropriate in this case, ordering SFL to pay *any* refunds would be "irresponsible," "financially dangerous," and "imprudent at best."[248] Appel also testified that if the Commissioner were to order refunds, allowing SFL to provide credits to its existing policyholders was one way the Commissioner could ". . . attempt to consider the financial condition of State Farm Lloyds."[249] Due to SFL's "extremely high" renewal rates, Appel believed that a substantial portion of SFL's existing policyholders were also policyholders in 2003.[250] He concluded: "If you offer credits on renewal, then there would be no immediate impairment to surplus and – the company could – you could, of course, review the surplus

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[247] Schwartz. 5 Tr. at 101.

[248] Hagar. 3 Tr. at 19. Appel. SFL Ex. 37 at 37.

[249] 5 Tr. at 316-317.

[250] *Id.* at 317.

levels over time to assure that the refunds were not causing any impairment that created any undue concern about State Farm Lloyds."[251]

In this vein, Staff's Crawshaw observed that while SFL "has the money" to pay the refunds and interest he recommended ($350 million), it would have "limited ability" to make "very large refunds" without more money.[252] He also volunteered that the payment of refunds "may raise a concern on the solvency side."[253]

OPIC's Schwartz, when pressed, admitted that OPIC's recommendation could result in refunds of "just under $800 million," which is approximately $1 billion if interest is included, an amount that is above SFL's current surplus.[254] He believed that if the appropriate refund amount would have an "overly adverse financial impact" on SFL, then it should pay part of the refund up front and hold the remainder as a "contingent liability" with that liability having a high priority of payment.[255] He also testified that in 2002 SFL had capital "well in excess" of the "Authorized Control Level" (ACL) ($79 million) and the "Company Action Level" (CAL) ($160 million) established by the National Association of Insurance Commissioners' (NAIC) Risk-Based Capital (RBC) formula.[256] Schwartz did not provide an estimate of what level of refunds constitutes an overly adverse

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[251] *Id*.

[252] 3 Tr. at 229. *See also* 4 Tr. at 63 for the $350 million value.

[253] 3 Tr. at 230.

[254] *See* 5 Tr. at 74 for the $800 million figure. This is combined with Schwartz's $240 million estimate of the interest, for a total of approximately $1 billion. *See* 5 Tr. at 81 for the $240 million figure. If the Commissioner ordered the immediate payment of approximately $1 billion in refunds and interest, SFL would become insolvent unless additional capital was provided by an affiliate, since SFL's current surplus is $918.1 million. *See also infra* fn. 273.

[255] 5 Tr. at 64-65.

[256] 5 Tr. at 47. If an insurer's surplus falls below the ACL, the Department is authorized to take control of that insurer. If an insurer's surplus falls below the CAL, which is twice the ACL, the insurer is required to file a plan to correct their financial condition.

financial impact, but instead pointed to factors the Commissioner could consider, including: (1) whether the refund would put SFL in violation of statutory requirements; (2) the NAIC's RBC formula; (3) other NAIC solvency tests; and (4) "various stress tests."[257]

In response to Schwartz's testimony regarding the NAIC's RBC formula, Appel replied that the RBC levels of capital are not SFL's "optimal capital level . . . reasonable capital level, or anything else," citing an NAIC circular that warned users not to use RBC in ratemaking.[258] Appel pointed out that the RBC formula is a system established by the NAIC in order to give insurance regulators authority to take control of companies under certain circumstances.

Analysis

Of all the many duties and responsibilities entrusted to the commissioner of insurance, one towers over all the others: the continuous monitoring and preservation of insurer solvency. The Preamble of the NAIC Accounting Practices and Procedures Manual states, "[t]he ultimate objective of solvency regulation is to ensure that policyholder, contract holder and other legal obligations are met when they come due . . . ."[259] The legislature, recognizing the harmful effects of insurer delinquencies, gave the commissioner tools necessary to take action when insurers are operating in a financially hazardous condition in an attempt to correct matters before they lead to an insurer's delinquency.[260] Texas Insurance Code, Chapter 441 is clear about the harmful effect of insurer delinquencies, stating insurer delinquencies create "a lack of public confidence in

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[257] 5 Tr. at 82.

[258] 5 Tr. at 304-305.

[259] *See* National Association of Insurance Commissioners' March 2009 Accounting Practices and Procedures Manual, page P-5 to P-6, paragraph 27.

[260] *See* TEX. INS. CODE ANN. §83.051, §404.003, and TEX. INS. CODE ANN. Ch. 441 (Vernon 2009).

insurance and insurers," and "destroy public confidence in the state's ability to regulate insurers."[261] Thus, the Legislature has given the commissioner the authority to intervene in matters touching on an insurer's financial condition. Given these mandates, it is not only appropriate but the Commissioner's statutory duty to consider the impact these refunds may have on SFL's financial condition.

In appraising the impact of refunds in the instant case, there are several unknowns that complicate the analysis. If SFL chooses to appeal, how long will the appellate process take before a final resolution can be obtained? Another six years? The precise calculation of post judgment interest is dependent on this variable. Also, unknown and unpredictable events such as a catastrophic hurricane could occur between now and the date any appeal is finalized. Despite these difficulties, the Commissioner is duty-bound to use his best judgment in assessing the impact of refunds on SFL's current financial condition.

Prior to any discussion of their impact, it is first necessary to estimate the refunds with interest due and payable under the terms of this Order. The following table estimates refunds and accrued interest as of the date of this Order.

[261] TEX. INS. CODE ANN. §441.001 (Vernon 2009).

| Policy Period | SFL Premiums[262] | Ordered Rate Reduction | Interest Factor | Dollar Refund [263] | Dollar Interest [264] | Total Interest and Refunds |
|---|---|---|---|---|---|---|
| Sept. 7, 2003 through Aug. 31, 2004. | $1,221.2 | -6.2% | 0.299 [265] | $75.7 | $22.6 | $98.3 |
| Sept. 1, 2004 through Aug. 31, 2005. | $1,273.3 | -3.4% | 0.246 [266] | $43.3 | $10.7 | $54.0 |
| Sept. 1, 2005 through Aug. 31, 2006. | $1,328.3 | -3.4% | 0.194 [267] | $45.2 | $8.8 | $54.0 |
| Sept. 1, 2006 through Aug. 31, 2007. | $1,410.9 | -3.4% | 0.141 [268] | $48.0 | $6.8 | $54.8 |
| Sept. 1, 2003 through Jul. 31, 2008. | $1,308.4 | -3.4% | 0.092 [269] | $44.5 | $4.1 | $48.6 |
| Total | $6,542.1 | N / A | N / A | $256.7 | $53.0 | $309.7 |
| Note: All dollar amounts shown are in millions of dollars. | | | | | | |

The "gross" amount of refunds set out in this Order is, therefore, $256.7 million, plus $53 million in accrued interest.[270] Staff's Crawshaw testified that "the

[262]Amounts in the table are the premiums shown in col. (2) of SFL Ex. 27 at 86, summed for the applicable policy periods.

[263] This is calculated as the amount shown in column labeled "SFL Premiums" multiplied by the amount shown in the column labeled "Ordered Rate Reduction."

[264] This is calculated as the amount shown in column labeled "Dollar Refund" multiplied by the amount shown in the column labeled "Interest Factor."

[265] The mid-point of this policy period is March 5, 2004. There are 68.33 months from March 5, 2004, to November 15, 2009. Hence, the factor used to compute interest is: (5.25% / 12) x 68.33 = 0.299.

[266] The mid-point of this policy period is March 2, 2005. There are 56.33 months from March 2, 2005, to November 15, 2009. Hence, the factor used to compute interest is: (5.25% / 12) x 56.33 = 0.246.

[267] The mid-point of this policy period is March 2, 2006. There are 44.33 months from March 2, 2006, to November 15, 2009. Hence, the factor used to compute interest is: (5.25% / 12) x 44.33 = 0.194.

[268] The mid-point of this policy period is March 2, 2007. There are 32.33 months from March 2, 2007, to November 15, 2009. Hence, the factor used to compute interest is: (5.25% / 12) x 32.33 = 0.141.

[269] The mid-point of this policy period is February 15, 2008. There are 21.00 months from February 15, 2008, to November 15, 2009. Hence, the factor used to compute interest is: (5.25% / 12) x 21.00 = 0.092.

[federal income] tax effect" will reduce the impact of the refunds on surplus. [271] If the tax effect is taken into account, the resulting calculation yields a reduction in surplus due to the payment of refunds and interest of approximately $201.3 million.[272] This, taken in conjunction with SFL's current surplus position, yields an expected surplus of $717 million.[273]

No party presented evidence in the form of a mathematical formula that would determine an appropriate surplus position for SFL. SFL's witnesses testified that even if refunds were appropriate based on the facts of the case, policyholders should not receive them. OPIC testified that notwithstanding the amount or their impact on SFL's financial condition, refunds should be paid. Staff testified that SFL may have a limited ability to pay very large refunds, but did not quantify this amount. In the context of refunds, SFL's Appel characterized a 1.0:1.0 premium-to-surplus ratio as a ratio that "would have been thought of as a minimally prudent ratio . . . ."[274] As SFL's Clapper testified, SFL achieved a 1.0:1.0 premium-to-surplus ratio in only one year (2007) during the period 2003 through third quarter 2008.[275] During this period, SFL paid approximately $400 million in principal back to SFMAIC, while most of the time maintaining surplus that was at least 10% below Appel's minimally prudent level of surplus.

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[270] "Gross" refers to the amount prior to consideration of effects due to federal income taxes or state premiums taxes.

[271] 4 Tr. at 63. He also testified there were two other possible effects, state premium taxes and commissions. *Id*.

[272] The income tax effect is $309.7 million x 0.35 = $108.4 million, for a surplus reduction of $309.7 million less $108.4 million = $201.3 million. *See also* 4 Tr. at 63.

[273] *See* Quarterly Statement as of June 30, 2009, of the Conditions and Affairs of State Farm Lloyds, page 3, line 35, "Surplus as Regards Policyholders" of $918.1 million. $918.1 million less $201.3 million equals $716.8 million.

[274] 5 Tr. at 313.

[275] SFL Ex. 35 at 5.

In the context of SFL's financial condition, the Commissioner does not accept Appel's characterization that a 1.0:1.0 premium-to-surplus level is minimally prudent, even though the Commissioner does accept this argument in the context of determining the underwriting profit provision.[276] The Commissioner does not find SFL is currently acting imprudently, which is implied by Appel's argument since its current surplus is below the level of 1.0:1.0. Instead, the Commissioner finds a 1.0:1.0 level of surplus can best be characterized as optimal. It would not only violate the clear statutory mandate, but would also be an injustice to SFL's current and past policyholders if the Commissioner were to order no refunds because SFL has not achieved an optimal level of surplus, while at the same time permitting and requiring SFL to make payments to SFMAIC. Interest payments to SFMAIC would be required under the terms of the surplus note since SFL's current surplus is above $700 million, and principal payments would be permitted given SFL's current surplus is above $900 million.

If SFL were to immediately pay both refunds and interest due in this order the Commissioner finds: (1) its surplus would be approximately $717 million; (2) the ratio of surplus to ACL capital would be less than 4; and (3) its premium to surplus ratio would be approximately 1.9:1.0.[277] While the immediate payment

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[276] There is a difference between the two. The NAIC recognized this difference, which SFL pointed out to OPIC's Schwartz, when they issued their circular cautioning the users of RBC not to use RBC to determine a target level of capital for rate setting. *See* 5 Tr. at 124.

[277] SFL is expected to have $716.8 million in surplus after payment of refunds and interest. Its net written premiums for the latest year available were $1.37 billion, giving an expected premium-to-surplus ratio of 1.91:1.0. TEX. INS. CODE ANN. § 822.205(b)(2) requires Lloyds plans, such as SFL, to maintain a ratio of net premiums to surplus of no more than 3.0:1.0. SFL reported the RBC formula produced an ACL of $190.6 million, and $716.8 million is 3.76 times this value. *See also* TDI Ex. 78 at 17 (page marked SFL-08 007623), line 29, "Authorized control level risk-based capital," column, 2008. The evidence of SFL's RBC ratio is being considered only for the limited purpose of evaluating SFL's financial condition after payment of refunds. It is not being considered, nor should anyone infer that it is appropriate to consider it, in rate-setting or determining a target level of capital for the purposes of determining an appropriate rate to be charged.

of refunds and interest would not place SFL in a hazardous financial condition, it is clear that the immediate payment of refunds would, based on financial information as of the second quarter 2009, substantially impact SFL's financial position. In recognition of this fact, and given the Commissioner has not only the responsibility to ensure SFL's policyholders are made whole but also the duty to ensure that SFL continues to operate safely and fulfill its contracts with current policyholders, the Commissioner finds the following modifications of the immediate payment of refunds and interest to be appropriate.

In accordance with Chapter 2254 of the Insurance Code, SFL may, in lieu of cash refunds, provide renewal credits to those policyholders with homeowners' policies in effect during the initial or subsequent periods, provided those customers renew with SFL. The renewal credits, including applicable post-Order interest, shall be applied over a period of no more than 12 months. SFL shall provide immediate payment of refunds and interest to policyholders with homeowners' policies in effect during the initial or subsequent periods and who are no longer insured by SFL, do not renew with SFL, or are otherwise terminated by SFL. Post-Order interest on all amounts due shall accrue at a rate of 9.25% until paid or credited.

Since Appel testified that SFL has a very high rate of policyholder retention, the evidence in the record supports the finding that the amounts that are required to be paid immediately will not have a significant impact on SFL's current financial condition.

## IX. FINDINGS OF FACT

### Preliminary Matters

1. The Austin Court of Appeals in an opinion dated May 22, 2008, remanded this matter for rehearing. *Geeslin v. State Farm Lloyds*, 255 S.W.3d 786 (Tex. App.—Austin 2008, no pet.).

2. Pursuant to the remand order, the Department on October 29, 2008, issued *Notice of Public Appeal Re-Hearing for Residential Property Insurance Rate Filed by State Farm Lloyds.*

3. The Office of Public Insurance Council (OPIC) filed Notice of Intervention on November 7, 2008.

4. Pursuant to Pre-Hearing Order No. 1 issued November 24, 2008, OPIC was permitted to participate.

5. The hearing was re-noticed and began on March 30, 2009, and continued on April 1, 2, 15, and concluded on May 2, 2009. All parties had an opportunity to present evidence and argument on each issue involved in the remand.

6. After submission of final briefs and completion of evidentiary offers, the record closed on November 16, 2006.

### State Farm Meets Its Initial Burden of Proof by Default

7. On January 21, 2004, three months after the September 2003 hearing, State Farm Lloyds (SFL) informed the Texas Department of Insurance (TDI) that it made an error when projecting its expected future premiums.

8. The effect of the premium error *decreased* TDI Staff's (Staff) and SFL's 2003 estimate of SFL's expected future premiums by approximately 8%.

9. Both Staff and SFL proffered testimony based on post-2003 hearing data to formulate rate indications that accounted for the premium error.

10. OPIC did not account for the premium error in any of its testimony, evidence, or calculations.

11. The premium error was inadvertent.

12. Staff, owing to the premium error and its changed position on the contingency provision, withdrew its original 12% rate reduction determination.

13. Staff instead put forth a revised analysis that SFL's rates should be reduced by: 9.2% from September 7, 2003, through June 30, 2004; by 7.3% from July 1, 2004, through June 30, 2005; and by 5.1% from July 1, 2005, through June 30, 2006.

14. SFL offered testimony from three different expert witnesses that the original rate reduction directed by Staff would produce inadequate and thus confiscatory rates.

**Rate Duration**

15. SFL charged one rate for the period beginning June 26, 2003, and continuing through July 31, 2008.

16. The rate charged during this period was never approved by TDI.

17. In the 2003 hearing, experts for both Staff and SFL presented rate indications based on the assumption that the rate would apply to policies with effective dates between September 2003 and September 2004.

18. In the present hearing, Staff and SFL offered rate indications based on the assumption that the rate would apply to policies with effective dates between September 2003 and September 2004.

19. Witnesses for Staff and SFL testified regarding what indications were appropriate for a rate to be applied after September 2004, although they disagreed regarding its duration.

20. SFL and OPIC argued that any rate determined should cover the period from September 2003 through July 31, 2008, citing in support of the ending date the fact that the Commissioner first approved a subsequently filed SFL rate on March 31, 2008, to be effective June 1, 2008, for new business and August 1, 2008, for renewal business.

21. Staff advocated an ending date of September 30, 2006, based on the testimony of Crawshaw, who opined that after October 1, 2006, SFL's rates ceased to be excessive and then became inadequate.

22. Crawshaw performed no actuarial analysis in reaching his conclusion, but relied entirely on the findings of fact and conclusion of law set out in a Proposal for Decision (PDF) issued on November 16, 2007, by Administrative Law Judges James W. Norman and William G. Newchurch regarding an SFL rate filing made in May 2006.

23. The November 16, 2007, PFD addressed the question of whether rates filed by SFL in 2006 were excessive. These rates were never implemented by SFL.

The PFD was not adopted by the Commissioner, is irrelevant in this case, and has no probative value. Crawshaw's opinion that, starting on October 1, 2006, SFL's rates ceased to be excessive and became inadequate lacks foundation.

24. OPIC testified that a single rate reduction should be applied from September 2003 through July 31, 2008. To support its position it argued a rate remains in effect until superseded by a newly filed rate, and SFL's rates remained at the same level of excessiveness for the entire period.

25. There is no evidence in the record to suggest SFL's rates remained at the same level of excessiveness for the entire period. There is evidence in the record to suggest the level of excessiveness of SFL's rates declined over time.

26. SFL's and Staff's testimony can be grouped into two sets of rate indications; one for an "initial period" of September 2003 to September 2004, and the other for the "subsequent period."

27. It is reasonable and necessary to make two separate rate determinations: one for an "initial period;" and, one for a "subsequent period."

28. TEX. INS. CODE art. 5.26-1(2)(b) provides that a rate determination becomes effective 30 days after the date the Commissioner notifies the insurer. The initial notice was issued August 8, 2003. Therefore, the beginning date is September 7, 2003.

29. The "initial period" is September 7, 2003, through August 31, 2004.

30. The "subsequent period" is September 1, 2004, through July 31, 2008, excluding new business written from June 1, 2008, through July 31, 2008.

**The Projected Earned Premiums: Initial Period**

31. When determining the rate for the initial period, Staff used a projected earned premium provision of $1,041.59, SFL $1,041.74, and OPIC $1,131.00.

32. SFL and Staff revised their projected earned premium provision to account for SFL's premium error; OPIC did not.

33. There is no evidence that SFL's premium error was anything other than a *bona fide* mistake.

34. Failure to account for the premium error would be unjust and unreasonable.

35. It is reasonable to use a projected earned premium provision of $1,041.59 when determining SFL's initial rate reduction.

**The Non-Catastrophe Loss and LAE Provision: Initial Period**

36. Staff and SFL provided a separate analysis for each of the following perils: (a) Fire, Other than Lightning (OTL); (b) Fire, due to lightning (Lightning); (c) Wind/Hail; (d) Other Extended Coverages (OEC); (e) Crime; and (f) Liability.

37. OPIC offered an analysis combining all perils.

38. A separate analysis by peril *can* reveal trends and insights that *may* not be revealed using an all-perils analysis.

39. Staff recommended a non-catastrophe loss and LAE provision of $300.10, SFL $332.45, and OPIC $339.13.

40. Staff and SFL's non-catastrophe loss and LAE provision reflect adjustments for information that was unknown but knowable in September 2003, whereas OPIC's provision did not.

41. In developing this provision, Staff and OPIC relied on the pure premium method, while SFL relied on the frequency/severity method.

42. The frequency/severity method and the pure premium method are common methods used to project non-catastrophe losses in homeowners' insurance ratemaking.

43. Allstate Texas Lloyds used the pure premium method to determine its non-catastrophe loss provision in the filing it submitted to comply with TEX. INS. CODE art. 5.26-1.

44. The hypothesis that frequency and severity are inherently negatively correlated is not a fundamental assumption of the pure premium method.

45. There is no evidence to suggest frequency and severity are inherently negatively correlated.

46. Staff's expert used the loss ratio method to calculate alternative non-catastrophe loss projections which confirmed his original pure premium projections.

47. Both Staff and SFL submitted data that was unknowable in September 2003 as evidence to either support or rebut the hypothesis that the ratio of losses to premiums at current rate level tend to be relatively stable over short periods of time.

48. Staff's loss ratio methodology assumes that: (a) the ratio of expected losses to premiums at current rate level tends to be relatively stable over short periods of time; or, (b) the trend in loss ratios ("net trend") tends to be close to 0% over short periods of time.

49. In this proceeding, SFL provided rate indications and their accompanying expected losses and premiums at current rate level for the period of 2004-2008 which showed no discernable upward or downward pattern in the ratio of expected losses to premiums at current rate level.

50. There are factors affecting losses which do not affect premiums and there are factors that affect premiums differently than they affect losses, but when the data is viewed in the aggregate, these factors tend to offset each other so that the ratio of expected losses to premiums at current rate level tends to be relatively stable over short periods of time.

51. It is reasonable to conclude in this proceeding, based on the evidence provided, that SFL's ratio of homeowners' expected losses to homeowners' premiums at current rate level tends to be relatively stable over short periods of time.

52. When deductibles are increasing they impact trends in several ways: frequencies decrease as more claims fall beneath the deductible; severity increases as smaller claims are eliminated; premiums decrease; and pure premiums decrease.

53. SFL projected frequency at 0% assuming there would be no more shifts in deductibles.

54. SFL projected severity in line with its historic trends.

55. Except for the wind/hail peril, Staff projected pure premium in line with SFL's historic trends.

56. Since Staff verified their pure premium projections using a loss ratio methodology, any effect due to deductible shifts on both premiums and losses was considered in Staff's non-catastrophe loss and LAE projections.

57. Increasing deductibles can cause a negative correlation between claim frequency and claim severity, but the evidence is not conclusive that the negative correlations between frequency and severity observed in SFL's data are due to deductible shifts.

58. SFL's frequency/severity projections were flawed not because it ignored correlations in the data, but because its assumptions regarding frequencies and/or severities were not reasonable.

59. It was reasonable for Staff's expert to perform reasonability checks on SFL's data that examine the relationship between premiums at current rate level and expected losses.

60. It was reasonable for Staff's expert to change his opinion about the reasonability of SFL's non-catastrophe loss projections since this change in opinion was based on data that had changed.

61. There is evidence suggesting SFL did not completely remove water damage losses no longer covered under its policy. Therefore, given this uncertainty, only partial weight is accorded to SFL's OEC data.

62. It is reasonable to include non-catastrophe loss adjustment expenses by multiplying projected non-catastrophe pure premiums by a factor of 0.2675.

63. SFL's provision for non-catastrophe loss and LAE of $332.45 is unreasonably high.

64. Staff's provision for non-catastrophe loss and LAE is more reasonable than OPIC's provision because: OPIC made no adjustments to account for reduced losses due to SFL's new building loss settlement form; and an analysis by peril is preferable to an analysis for all perils combined.

65. It is reasonable to use a non-catastrophe loss and LAE provision of $300.10 when determining SFL's initial rate reduction.

**The Non-Hurricane Catastrophe Loss and LAE Provision: Initial Period**

66. Catastrophe events are large fortuitous events that cause widespread property damage; they are unpredictable, and, in the context of Texas homeowners insurance, are almost always weather-related.

67. SFL determined its non-hurricane catastrophe loss and LAE provision by analyzing over 20 years of actual Texas homeowners data, and relating non-hurricane catastrophe losses to amount of insurance years (AIY).

68. Staff reviewed SFL's methodology for developing its non-hurricane catastrophe loss and LAE provision and found it to be reasonable.

69. OPIC objected to SFL's inclusion of an adjustment to account for trends in the ratio of non-hurricane catastrophe losses to AIY.

70. There is sufficient evidence to conclude there is a trend in SFL's ratio of non-hurricane catastrophe losses to AIY.

71. SFL's provision for non-hurricane catastrophe loss and LAE is reasonable.

72. It is reasonable to use a non-hurricane catastrophe losses and LAE provision of $244.14 in determining SFL's initial rate reduction.

**The Hurricane Catastrophe Loss and LAE Provision: Initial Period**

73. Hurricanes are infrequent, potentially solvency-threatening events that are difficult to address in projecting future costs for ratemaking purposes.

74. The use of hurricane models is a generally accepted actuarial approach when determining the provision for hurricane catastrophe losses and no party objected to their use in this proceeding.

75. SFL developed its hurricane loss provision using two separate hurricane models: EQECAT's USWIND™, and Risk Management Solution, Inc.'s RiskLink™. .

76. Staff's expert concluded SFL's methodology for developing its hurricane loss and LAE provision was reasonable and the results were in line with his expectations based on his experience reviewing other Texas homeowners' rate filings.

77. OPIC reduced SFL's hurricane loss and LAE provision because it included a factor of 1.1254 for loss adjustment expense, rather than a factor of 1.070 as set out by SFL.

78. SFL made typographical errors in their June 26, 2003, rate filing which could reasonably lead to the conclusion that a factor of 1.1254 was used to add loss adjustment expense rather than a factor of 1.070. There is no evidence suggesting that SFL actually used a factor of 1.1254 to load loss adjustment expense.

79. SFL's provision for hurricane catastrophe loss and LAE is reasonable.

80. It is reasonable to include a provision of $68.30 for hurricane catastrophe loss and LAE when determining the initial rate reduction.

**The Fixed Expense Provision: Initial Period**

81. In determining its fixed expense provision, SFL relied solely upon its fixed expense data for 2002, projecting those expenses at 3% per annum, resulting in a fixed expense provision of $118.34.

82. In determining its fixed expense provision, Staff discounted SFL's 2002 fixed expense data, using a fixed expense provision of $90.00.

83. SFL's historical fixed expenses increased from $79.08 in 2001 to $110.98 in 2002.

84. The increase in SFL's fixed expense data was caused by two major factors: (a) a growing level of liability for agent termination payments; and (b) increased expenses for information technology.

85. The increase in liabilities for agent termination payments was primarily caused by: (a) increases in rate levels which affect commission levels, the basis of termination payments; and (b) a reduction in the discount rate used to value the present value of future termination payments.

86. Staff's testimony was undisputed that changes in the discount rate used to calculate the present value of future termination payments causes a one-time, temporary, increase in expenses which is not indicative of expected future expenses.

87. Absent evidence to the contrary, the increase in information technology expenses from 2001 to 2002 is indicative of expected future expenses.

88. Some of the costs included in SFL's 2002 fixed expense data are indicative of expected future expenses, and others are not.

89. Staff's fixed expense provision of $90.00 completely ignored SFL's 2002 fixed expense data and is, therefore, unreasonably low.

90. SFL's fixed expense provision of $118.34 solely relied on SFL's 2002 fixed expense data and is, therefore, unreasonably high.

91. An appropriate method for determining SFL's fixed expenses gives weight to SFL's 2002 fixed expense data but does not solely rely upon it.

92. It is reasonable to calculate SFL's fixed expense provision based on three years of SFL's fixed expense data (2000-2002), projecting fixed expenses at a rate of 3% per annum.

93. It is reasonable to include a provision of $100.34 for fixed expenses when determining the initial rate reduction.

**The Variable Expense Provision: Initial Period**

94. SFL and Staff each recommended a variable expense provision of 15.4%.

95. OPIC recommended a variable expense provision of 15.7%.

96. It is reasonable to include a provision of 15.4% for variable expenses when determining the initial rate reduction.

**The Reinsurance Expense Provision: Initial Period**

97. There are two reinsurance contracts at issue in this proceeding: SFL's stop loss reinsurance contract; and its catastrophe reinsurance contract. Each

contract was entered into with SFL's affiliate company, State Farm Mutual Automobile Insurance Company (SFMAIC).

98. ASOP No. 29 "Expense Provisions in Property Casualty Insurance Ratemaking" provides that actuaries may consider a provision for reinsurance costs in the rates, but the actuary should consider commissions received by the reinsured, and amounts the reinsured is expected to recover under the contract in addition to reinsurance premiums paid.

99. SFL included in its rates a provision of 1.9% of premium for the net costs of its stop loss reinsurance contract.

100. SFL included in its rates a "Hurricane Risk Provision" of 1.4% of premium. Included in this provision was 1.2% of premium for the net cost of its catastrophe reinsurance contract, the remainder was a retained risk provision, which is a charge to compensate SFL for the risk of hurricanes.

101. Staff included in the rates, provisions of 1.9% of premium and 1.4% of premium for the net cost of SFL's stop loss and catastrophe reinsurance treaties, respectively.

102. Approximately 0.2% of the 1.4% catastrophic reinsurance provision used by Staff was a retained risk provision.

103. The risk associated with SFL's retained risk provision is contemplated when determining the underwriting profit and contingencies provision. Therefore, including a 0.2% retained risk provision in the reinsurance costs would count this risk twice.

104. OPIC objected to the inclusion of the cost of SFL's stop loss contract, citing three reasons: (a) ratemaking is done on a direct basis; (b) the expected

recoveries under the treaty were not reflected in the net cost; and (c) any profits earned under the stop loss treaty would stay within the control of the State Farm group.

105. OPIC objected to the inclusion of SFL's Hurricane Risk Provision on the basis it considered it superfluous and an unneeded profit provision.

106. The 1.9% provision for SFL's stop loss contract includes an offset of 0.6% of premium for recoveries expected under the contract.

107. There is no evidence to suggest the premium charged by SFL's affiliate for the reinsurance contracts was uncompetitive or the reinsurance premium included unnecessary profit to the affiliate company.

108. It is reasonable to include a provision of 1.9% of premium for the net cost of SFL's stop loss contract when determining the initial rate reduction.

109. It is reasonable to include a provision of 1.2% of premium for the net cost of SFL's catastrophe reinsurance contract when determining the initial rate reduction.

**The Contingency Provision: Initial Period**

110. SFL's rate determination included a 2.0% contingency provision, the purpose of which was to offset any difference between the actual and expected results.

111. Staff and SFL both referenced and submitted for the record ASOP No. 30, which defines a contingency provision as: "A provision for the expected difference, if any, between the estimated costs and the average actual costs that cannot be eliminated by changes in other components of the ratemaking process."

112. Staff and OPIC each rejected SFL's 2.0% contingency provision as unnecessary, inappropriate, or not adequately supported by SFL.

113. During rebuttal, SFL offered additional evidence showing a pattern of significant shortfalls between expected and actual results based on filings in 46 states other than Texas. The additional evidence was based on rates actually implemented, rather than rate indications which may have been developed earlier in the ratemaking process, before selection of a different rate for approval and, ultimately, implementation. This aspect of the evidence effectively addressed one of the concerns cited by Staff in its earlier rejection of the 2% contingency provision.

114. Following the provision of this additional evidence, Staff changed its position. Staff's witness described the additional analysis as "better than we've seen before" and went on to say "I'm no longer arguing about the contingency load." In effect, Staff assented to inclusion of the 2% contingency provision.

115. OPIC did not change its position on the contingency provision. After pointing to the ability of trending projections to overcome some potential sources of systematic variation described by SFL, OPIC's witness noted that other changes in the ratemaking process, and a change in the policy form relating to mold coverage may have caused some or all of the shortfalls due to variations between expected and actual costs. OPIC concluded SFL's analysis had limited relevance going forward, and did not provide adequate support for the inclusion of a 2.0% contingency provision.

116. The testimony of OPIC's witness raised legitimate questions about the relevance or reliability of the SFL contingency provision analyses.

117. It is not clear the extent to which changes in ratemaking procedures during the years analyzed or in subsequent years have effectively eliminated the cause of shortfalls. It is also unclear how any policy form changes, including those related to mold coverage, effectively addressed shortfalls which occurred in the past.

118. The record contains no meaningful analysis of other possible explanations of prior shortfalls, such as how competitive pressure may have influenced rating classification application and, thus, premiums actually charged.

119. The evidence does not support a conclusion that there is a systematic variation between expected costs and actual costs. Thus the inclusion of a specific 2.0% contingency provision in the ratemaking formula is inappropriate. However, the evidence does support a conclusion that there *may be* a systematic variation between expected costs and actual costs.

120. The conclusion that there may be a systematic variation between expected costs and actual costs implies risk, and this risk can be considered and addressed in deriving an appropriate underwriting profit and contingencies provision.

**The Surplus Note Provision**

121. SFL's filing includes a 9.0% of premium provision to reflect the costs – both principal and interest – associated with surplus notes totaling $1.05 billion which were issued by SFL in 2001 and 2002.

122. A consolidated surplus debenture issued in 2002 reflects both the $1.05 billion borrowed by SFL and its obligation to repay the principal, along with 7.0% interest, by December 31, 2016.

123. The form and substance of the surplus note were approved by TDI under Commissioner's Order #02-1021.

124. SFL proposed a 9.0% surplus note provision in addition to an underwriting profit provision of 5.0%, based on a profit model intended to allow a reasonable cost of capital.

125. Both Staff and OPIC rejected SFL's surplus note provision, viewing such provision as effectively being a second profit provision or a second provision for capital costs, which costs are already contemplated in the underwriting profit model and, therefore, in the 5.0% underwriting profit provision.

126. Staff and OPIC are correct to reject SFL's 9.0% surplus note provision. Allowing a separate provision for a write-down or amortization of SFL's surplus note and related interest would be tantamount to allowing two returns on capital in the ratemaking formula.

127. While the inclusion of the separate 9.0% surplus note provision in the ratemaking formula would be unreasonable, it is reasonable to consider the existence of the surplus note, and the need for both the principal and related interest to be paid by December 31, 2016, in considering the reasonableness of the underwriting profit provision. Specifically, the Commissioner finds it is reasonable to consider the existence of the surplus note, and SFL's obligation to timely repay it when determining: (1) the level of risk faced by SFL in writing homeowners insurance in 2003; (2) an appropriate premium to surplus ratio or cost of capital; and (3) an appropriate underwriting profit provision.

**The Underwriting Profit and Contingencies Provision: Initial Period**

128. SFL proposed an underwriting profit provision of 5.0%, based on a profit model which contemplated investment income, a 1.0:1.0 premium to surplus ratio, a 1.4% hurricane risk provision and a 9.6% return on GAAP equity.

129. SFL's 1.0:1.0 premium to surplus ratio represents a theoretical level of surplus in relation to premium, SFL's actual surplus being much smaller in 2003 due to significant losses in prior years.

130. Use of a theoretical, as opposed to actual, level of surplus in deriving an underwriting profit provision is a widely accepted practice.

131. Staff also recommended a 5.0% underwriting profit provision, utilizing the same profit model used by SFL, but with a slightly greater expectation for investment income, which translated into a slightly greater, 9.9% return on GAAP equity, which Staff deemed to be reasonable.

132. OPIC suggested a 2.5% profit provision based largely on consideration of a 1.0% profit provision previously used in a TDI benchmark rate decision, with judgmental adjustments for changes that occurred between adoption of the 1.0% and the 2003 SFL filing.

133. OPIC's 2.5% profit recommendation was not directly supported by any model relating the 2.5% profit to any particular return on GAAP equity in conjunction with an explicit premium to surplus ratio or other leverage factor and an explicit estimate of expected investment income.

134. The small difference between SFL and Staff regarding the expected investment income was adequately addressed by SFL in their pre-filed response testimony.

135. It is reasonable to use SFL's profit model in deriving an underwriting profit provision for use in this case, but further consideration of the premium to surplus ratio used in the profit model is appropriate.

136. SFL's theoretical premium to surplus ratio was described by SFL as being "minimally prudent."

137. One SFL witness testified that analyses of premium to surplus ratios for professional reinsurers and Bermuda property reinsurers, combined with "the fact that SFL is not charging anything in the rate for catastrophe reinsurance" could justify a premium to surplus ratio as low as 0.5 to 1.0. Elsewhere in his testimony, the same witness acknowledges that SFL has made some provision for catastrophe reinsurance, but that, "since many exposures are not covered by the catastrophic reinsurance coverage and since in Texas, many catastrophes are too small to exceed the reinsurance deductible (or 'attachment point'), the coverage is incomplete."

138. Other evidence in the record demonstrates that SFL is making significant provision for catastrophe reinsurance.

139. The fact that SFL is making significant provision for catastrophe reinsurance greatly diminishes SFL's assertion that a premium to surplus ratio as low as 0.5:1.0 could be justified; but the fact that some catastrophe exposure is not fully covered by reinsurance offers some support for using a premium to surplus ratio of modestly less than 1.0:1.0.

140. The justification for using a premium to surplus ratio of less than 1.0:1.0 is strengthened significantly when other elements of risk are considered.

141. The fact that SFL is a single-state insurer deriving almost its entire premium from a single line of insurance which includes catastrophe coverage in a catastrophe-prone state was brought forth in the record as an indication of risk.

142. As noted earlier in the FOF 127, the existence of a surplus note, and the obligation to repay such note by a date certain, along with related interest, is an element of risk inherent in SFL's writing of homeowners insurance in 2003.

143. The element of risk associated with repaying a surplus note, plus interest, would not be present in a typical insurer, which has no surplus notes, and would not be prominent in an aggregation of all insurers, as most insurers do not have surplus notes.

144. SFL's surplus note, and the obligation to repay it, along with related interest, suggests that an otherwise reasonable premium to surplus ratio, or what might be construed as a "minimally prudent" premium to surplus ratio, may not be reasonable to determine an appropriate underwriting profit provision with respect to SFL's writing of homeowners insurance in 2003.

145. SFL's surplus note, and the obligation to repay it, along with related interest, by December 31, 2016, suggests that the use of a lower premium to surplus ratio to determine the underwriting profit provision may be, in consideration of SFL's writing of homeowners insurance in 2003, more reasonable than the 1.0:1.0 ratio used in SFL's analysis.

146. As noted earlier in FOF 120, the conclusion that there may be a systematic variation between expected costs and actual costs implies risk.

147. To the extent such risk is not contemplated in the 1.0:1.0 premium to surplus ratio used in the SFL profit model, there is a basis for using a premium to surplus ratio lower than 1.0:1.0.

148. The Commissioner finds: (1) SFL is a single-state writer, writing almost exclusively homeowners insurance, which includes catastrophe coverage, in a catastrophe-prone state; (2) SFL faces an element of risk associated with the obligation to repay the $1.05 billion surplus note, along with related interest by a date certain; and (3) there may be systematic variation between expected costs and actual costs which has not been addressed in the ratemaking process. For these reasons, it is reasonable to accord to SFL's writing of homeowners insurance *in 2003* a greater measure of risk than is contemplated in the 1.0:1.0 premium to surplus ratio contained in SFL's profit model. A reasonable premium to surplus ratio for use in this proceeding would be somewhere below 1.0:1.0, but well above 0.5:1.0. The profit provisions consistent with such a range of premium to surplus ratios are in the range of 7.0% to 10.0%. The Commissioner also finds that some, if not all, of the conditions warranting the modification of the profit model are temporary in nature.

149. 8.5% is a reasonable profit and contingencies provision, including a provision for hurricane risk, for SFL in conjunction with its writing of homeowners insurance in Texas in 2003.

**The Initial Rate Reduction**

150. Based on FOF 35, 65, 72, 80, 93, 96, 108, 109, 120, 127, and 149, a reasonable rate reduction for the initial period for SFL is –6.2%, as calculated in the following table:

| | Rate Provision | Amount |
|---|---|---|
| (1) | Projected Earned Premium | $1,041.59 |
| | | |
| (2) | Non-Catastrophe Loss and LAE | $300.10 |
| (3) | Non-Hurricane Catastrophe Loss and LAE | $244.14 |
| (4) | Hurricane Catastrophe Loss and LAE | $68.30 |
| (5) | Fixed Expense | $100.34 |
| (6) | Subtotal – Loss, LAE, fixed Expense [(2)+(3)+(4)+(5)] | $712.88 |
| | | |
| (7) | Variable Expense | 15.4% |
| (8) | Surplus Note | 0.0% |
| (9) | Net Cost of Reinsurance – Catastrophe Treaty | 1.2% |
| (10) | Net Cost of Reinsurance – Stop Loss Treaty | 1.9% |
| (11) | Underwriting Profit and Contingencies Provision | 8.5% |
| (12) | Subtotal – Variable rate provision [(7)+(8)+(9)+(10)+(11)] | 27.0% |
| | | |
| (13) | Indicated Premium [(6) / {1.0 - (12)}] | $976.55 |
| (14) | Indicated Rate Change [(13) / (1) – 1.0] | -6.2% |

**Determining a Rating Methodology for the Subsequent Period**

151. One SFL expert, Kelley, testified that he developed two actuarially appropriate methods, both prospective in nature, to determine the rate after September 1, 2004.

152. Kelley's first method, the *Trend Projection Method*, developed a rate indication by extending trend projections used to originally develop those ratemaking components.

153. Under the *Augmented Data Method*, rate indications were determined for subsequent periods by augmenting the historical data contained in the June 26, 2003, filing one piece at a time.

154. Kelley testified both methods were actuarially appropriate and prospective in nature, but gave a slight preference to the *Augmented Data Method*.

155. Both Staff and OPIC objected to SFL's *Augmented Data Method*, stating it produced excessive rates.

156. Staff did not oppose SFL's *Trend Projection Method*.

157. OPIC objected to SFL's *Trend Projection Method* because: (1) it believed the starting point rate indication was excessive; and (2) SFL assumed net trend will increase the rate indication, whereas OPIC believed that net trends remain flat or decrease over time.

158. Staff only calculated rate indications through July 1, 2006.

159. Staff, through its expert Crawshaw, proposed a methodology that used interpolation to determine almost all of the ratemaking provisions. All of the ratemaking provisions, except for reinsurance costs, were calculated as values that were interpolated between Crawshaw's initial rate reduction and the +3.6% rate change recommended in the Norman/Newchurch PFD. Staff calculated reinsurance costs as actual costs.

160. Both OPIC and SFL objected to Staff's methodology as being neither actuarially appropriate nor prospective.

161. Staff's methodology relied on a PFD which has no probative value in this case.

162. OPIC recommended the rate reduction determined in the initial period be applied in the subsequent period.

163. OPIC provided two reasons as the basis for its recommendation: (1) insurer's rates remain in effect until superseded by a new rate; and (2) SFL rates remained at the same level of excessiveness for the entire period.

164. There is no evidence in the record to suggest that SFL's rates remained at the same level of excessiveness for the entire period. There is evidence in the record that suggests the level of excessiveness in SFL's rates declined over time.

165. Both Staff and SFL provided testimony that, for the catastrophe loss and LAE provisions, a net trend greater than 0% is reasonable. Staff, OPIC, and SFL all provided testimony that, for the fixed expense provision, a net trend greater than 0% is reasonable.

166. SFL's *Trend Projection Method* has the advantage that it relies on its June 26, 2003, rate filing, for which a record has been fully developed.

167. SFL's *Trend Projection Method* is most suitable for determining a rate for SFL for the subsequent period.

**Determining the Rate for the Subsequent Period**

168. In this proceeding, only the following rate provisions were trended: earned premiums; non-catastrophe loss and LAE; non-hurricane catastrophe loss and LAE; hurricane catastrophe loss and LAE; and fixed expenses.

169. No party recommended that variable expenses or reinsurance costs be trended.

170. It is reasonable to use the following annual trends, as recommended by the various experts, when determining the rate for the subsequent period.

| Rate Provision | Annual Trend Percentage |
|---|---|
| Earned premiums | 1.30% |
| Non-catastrophe loss and LAE | 1.30% |
| Hurricane catastrophe loss and LAE | 1.80% |
| Non-hurricane catastrophe loss and LAE | 4.85% |
| Fixed expenses | 3.00% |

171. In order to determine the rate for the subsequent period, it is necessary to trend the applicable rate provisions to the average loss date for the subsequent period which is February 15, 2007, or 2.46 years after the average loss date of the initial period.

172. Applying FOF 170 and FOF 171 to the rate provisions recommended in FOF 35, 65, 72, 80, and 93, results in the following rate provisions.

| Rate Provision | Trended Amount |
|---|---|
| Earned premiums | $1,075.22 |
| Non-catastrophe loss and LAE | $309.79 |
| Hurricane catastrophe loss and LAE | $71.36 |
| Non-hurricane catastrophe loss and LAE | $274.31 |
| Fixed expenses | $107.91 |

173. During the subsequent period SFL repaid approximately $400 million, or more than one-third, of the surplus note principle.

174. At least two SFL witnesses testified that SFMAIC has little or no economic incentive to provide SFL additional capital, given the historic losses SFL has suffered.

175. It is reasonable to consider the repayment of $400 million of surplus note principle during the subsequent period when evaluating the risk associated with the repayment of the $1.05 billion surplus note, but this fact is also tempered by FOF 174.

176. A reasonable underwriting profit provision used to determine the rate in the subsequent period is 8.0%.

177. In addition to the rate provisions contained in FOF 172 and FOF 176, the record supports the use of the following rate provisions for the subsequent period.

| Rate Provision | Amount |
|---|---|
| Variable expenses | 15.4% |
| Reinsurance costs – catastrophe treaty | 1.2% |
| Reinsurance costs – stop loss treaty | 1.9% |

178. The rate reduction for the subsequent period is -3.4%, as calculated in the table below.

| | Rate Provision | Amount |
|---|---|---|
| (1) | Projected Earned Premium | $1,075.22 |
| | | |
| (2) | Non-Catastrophe Loss and LAE | $309.79 |
| (3) | Non-Hurricane Catastrophe Loss and LAE | $274.31 |
| (4) | Hurricane Catastrophe Loss and LAE | $71.36 |
| (5) | Fixed Expense | $107.91 |
| (6) | Subtotal – Loss, LAE, fixed Expense [(2)+(3)+(4)+(5)] | $763.37 |
| | | |
| (7) | Variable Expense | 15.4% |
| (8) | Surplus Note | 0.0% |
| (9) | Net Cost of Reinsurance – Catastrophe Treaty | 1.2% |
| (10) | Net Cost of Reinsurance – Stop Loss Treaty | 1.9% |
| (11) | Underwriting Profit and Contingencies Provision | 8.0% |
| (12) | Subtotal – Variable rate provision [(7)+(8)+(9)+(10)+(11)] | 26.5% |
| | | |
| (13) | Indicated Premium [(6) / {1.0 - (12)}] | $1,038.60 |
| (14) | Indicated Rate Change [(13) / (1) – 1.0] | -3.4% |

**Refunds**

179. The prime rate of interest published in *The Wall Street Journal* on the first day of the calendar year 2003 that was not a Saturday, Sunday or legal holiday was 4.25%. Therefore, the prime rate plus 1% is 5.25%.

180. The prime rate of interest published in *The Wall Street Journal* on the first day of the calendar year 2009 that was not a Saturday, Sunday or legal holiday was 3.25%. Therefore, the prime rate plus 6% is 9.25%.

181. The amount of premium SFL overcharged its policyholders is less than 7.5% of the total premium it charged its policyholders.

182. The gross amount of refunds set out in this order is approximately $256.7 million, plus $53.0 million in accrued Article 5.26-1 interest, for a total amount of refunds and interest of approximately $309.7 million.

183. No party presented evidence in the form of a mathematical formula that would determine an appropriate surplus position for SFL.

184. SFL's witnesses testified that even if refunds were appropriate based on the facts of this case, policyholders should not receive them.

185. OPIC's witness testified that notwithstanding the amount, or their impact on SFL's financial condition, refunds should be paid.

186. Staff's witness testified that SFL may have a limited ability to pay very large refunds, but did not quantify this amount.

187. During the period of 2003-2009, SFL paid approximately $400 million in principle back to SFMAIC, while most of the time maintaining surplus that

was at least ten percent below the level of surplus determined by a 1.0:1.0 premium-to-surplus ratio.

188. In the context of SFL's operations, a 1.0:1.0 premium-to-surplus ratio may best be characterized as "optimal," and not "minimally prudent."

189. After the immediate payment of the refunds and Article 5.26-1 interest set out in this Order, SFL is expected to have surplus of approximately $717 million, which results in the following financial ratios: (1) a ratio of surplus to ACL capital of approximately 3.76:1.0; and (2) a premium to surplus ratio of approximately 1.91:1.0.

190. The immediate payment of refunds and interest will not place SFL in a hazardous financial condition, but based on financial information as of the second quarter 2009, will substantially impact SFL's financial position.

191. Given Finding of Fact 190, SFL may, in lieu of cash refunds, provide renewal credits to those policyholders who had homeowners' policies in effect during the initial or subsequent periods, provided those policyholders renew with SFL, and provided post-Order interest on all amounts due shall accrue at a rate of 9.25% until paid or credited.

192. It is appropriate for SFL to provide immediate payment of refunds and interest to policyholders with homeowners' policies in effect during the initial or subsequent periods, and who are no longer insured by SFL, do not renew with SFL, or are otherwise terminated by SFL.

193. Due to SFL's very high rate of policyholder retention, the amounts that are required to be paid immediately will not have a significant impact on SFL's current financial condition.

## X. CONCLUSIONS OF LAW

1. The Commissioner of Insurance has jurisdiction over this matter. TEX. INS. CODE arts. 1.02, 5.26-1, 5.142.

2. All parties received proper and timely notice of hearing. TEX. GOV'T CODE § 2003.021.

3. It was legally appropriate and necessary to consider evidence based on post-2003 hearing data to formulate rate indications that accounted for the SFL's premium error.

4. Staff has exclusive jurisdiction to initially determine a rate under TEX. INS. CODE art. 5.26-1 (2)(b).

5. Staff withdrew its original 12% rate reduction determination.

6. OPIC has no standing to object to Staff's withdrawal of Staff's 12% rate reduction determination.

7. The rate standards governing this proceeding are set out in TEX. INS. CODE arts. 1.02, 5.142 and ch. 2251.

8. A rate must permit an insurer a reasonable return on its investments sufficient to assure confidence in the continued financial integrity of the enterprise.

9. The return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. The returns in the instant case are measured against the returns of other insurers writing homeowners insurance in Texas.

10. A rate, to be "just and reasonable," must appraise and balance the interests of the insurer, the insured and the public.

11. The Commissioner has broad discretion to determine a rate above one that is confiscatory and below one that is excessive.

12. SFL met its initial burden of proof to show, by clear and convincing evidence, that the 12% reduction determined by the Department will produce a confiscatory rate.

13. The rate filed by SFL on June 26, 2003, was excessive for the risks to which it applies.

14. Given Conclusions of Law Nos. 8 and 12, the issue for determination was the development of rates chargeable by SFL which are just and reasonable and neither confiscatory nor excessive for the risks to which they apply.

15. Neither Staff nor SFL bore the burden of production or persuasion on this issue.

16. During the initial period, the following provisions will produce a rate that is just and reasonable and neither confiscatory nor excessive for the risks to which they apply:
    a. projected earned premiums, a value of $1,041.59;
    b. non-catastrophe loss and LAE, a value of $300.10;
    c. SFL's non-hurricane catastrophe loss and LAE value of $244.14;
    d. SFL's hurricane catastrophe loss and LAE value of $68.30;
    e. fixed expenses, a value of $100.34;
    f. SFL's variable expense value of 15.4%;
    g. SFL's stop loss reinsurance value of 1.9%;

h. SFL's catastrophe reinsurance value of 1.2%;

i. For the surplus note, a value of 0.0 %; and

j. For underwriting profit and contingencies, a value of 8.5%.

17. It is unreasonable to include principle and interest payments on the surplus note as an expense in SFL's rates.

18. Inclusion of the principal and interest payments on the surplus note as an expense in addition to rate provisions which already contemplate SFL's expected future costs, including its cost of capital, will produce excessive rates.

19. Inclusion of a contingency provision over and above a reasonable underwriting profit provision which reflects the risks of SFL writing homeowners insurance in Texas in 2003 will produce excessive rates.

20. A rate reduction of -6.2%, as determined in FOF 150, produces rates that are both just and reasonable and neither excessive nor confiscatory for the period September 7, 2003, through August 31, 2004.

21. During the subsequent period, the following provisions will produce a rate that is just and reasonable and neither confiscatory nor excessive for the risks to which they apply:

a. For projected earned premiums, a value of $1075.22;

b. For non-catastrophe loss and LAE, a value of $309.79;

c. SFL's non-hurricane catastrophe loss and LAE value of $274.31;

d. SFL's hurricane catastrophe loss and LAE value of $71.36;

e. For fixed expenses, a value of $107.91;

f. SFL's variable expense value of 15.4%;

g. SFL's stop loss reinsurance value of 1.9%;

h. SFL's catastrophe reinsurance value of 1.2%;

i. For the surplus note, a value of 0.0%; and

j. For underwriting profit and contingencies, a value of 8.0%.

22. A rate reduction of -3.4%, as determined in FOF 178, produces rates that are both just and reasonable and neither excessive nor confiscatory for the period September 1, 2004, through July 31, 2008, excluding new policies written from June 1, 2008, through July 31, 2008.

23. The Commissioner of Insurance has the jurisdiction and authority under Insurance Code article 5.26-1 and Insurance Code Chapter 2254 to adjudicate all issues regarding refunds payable to SFL policyholders.

24. The interest component set out in both Article 5.26-1 and Chapter 2254 is analogous to post-judgment interest and is intended to compensate insureds for the time-value of money should an insurer lose on appeal.

25. To fully compensate SFL insureds for the time-value of money as required by Article 5.26-1, interest accrues from September 7, 2003, which is 30 days following Staff's notification that SFL's rates were excessive.

26. To fully compensate SFL insureds for the time-value of money as required by Chapter 2254, interest accrues from the date of this Order until paid.

27. The Commissioner has no authority under either Article 5.26-1 or Chapter 2254 to consider the financial impact of refunds with respect to their calculation, but he has full authority to consider their financial impact in determining the protocol under which they are to be paid.

28. When the excessive portion of the premium is less than 7.5% of the total premium, Insurance Code Chapter 2254 authorizes the Commissioner of

Insurance to permit an insurer to apply a future premium discount equal to the amount of the excessive portion of the premium, plus interest on that amount to policyholders who renew their policy.

29. Insurance Code Chapter 2254 requires the Commissioner of Insurance to Order refunds for policyholders who do not renew or whose coverage is otherwise terminated.

## XI. ORDER

**IT IS THEREFORE THE ORDER** of the Commissioner of Insurance that within sixty (60) days from the date of this Commissioner's Order, State Farm Lloyds shall provide renewal credits or return to each affected policyholder all excessive premium with accrued interest as determined in this Order. All applicable renewal credits together with interest shall be applied beginning within sixty (60) days of the date of this Order and must be applied for all applicable policyholders within 12 months following the specified sixty (60) days. All refunds and interest required to be paid, excluding refunds and interest issued through renewal credits, shall be made by check within sixty (60) days and shall be mailed to the policyholder's last known address or most recent available address via certified mail, return receipt requested, in an envelope that requests both forwarding and address corrections and that contains a notation, "Refund of Homeowner's Premium Information Enclosed." All returned, return receipt cards or green cards, whether signed or not, shall be maintained by State Farm Lloyds for a period of five years and shall be made available for inspection and review by the Department upon request.

**IT IS FURTHER THE ORDER** of the Commissioner of Insurance that for those recipients who cannot be located, the total amount of their respective refund

checks, including checks that are returned as "undeliverable," shall be deposited by State Farm Lloyds into a separate account in a financial institution, and within one hundred twenty (120) days from the date of this Order said account, including all interest accrued thereon, shall be turned over to the Comptroller of Public Accounts of the State of Texas as abandoned property pursuant to the procedure specified in TEX. PROP. CODE ANN. §§ 72.001-75.001, et seq. Full compliance with this Order requires that copies of all correspondence and reports provided by State Farm Lloyds to the Comptroller of Public Accounts shall also be provided to Elizabeth (Lisa) Olmos, or her successor, Texas Department of Insurance, MC 113-2A, P.O. Box 149104, Austin, TX 78714-9104.

**IT IS FURTHER THE ORDER** of the Commissioner of Insurance that within six (6) months from the date all refunds are required to be paid or credited by this Order, State Farm Lloyds shall file with the Department a report fully accounting of all refunds to each policyholder, including the policyholder name, address, policy number(s), and total refund including interest paid to each policyholder; and the total number of refund checks unclaimed to date, along with the policyholders' names associated with the unclaimed checks. This report shall be mailed or delivered to Elizabeth (Lisa) Olmos, or her successor, Texas Department of Insurance, MC 113-2A, P.O. Box 149104, Austin, TX 78714-9104.

**AND IT IS SO ORDERED**.

Signed this 16th day of November, 2009

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MIKE GEESLIN
COMMISSIONER OF INSURANCE

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