

# State Office of Administrative Hearings

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BY: *OS*

Cathleen Parsley  
Chief Administrative Law Judge

August 19, 2013

Julia Rathgeber  
Commissioner of Insurance  
Texas Department of Insurance  
333 Guadalupe, Tower 1, 13<sup>th</sup> Floor, Mail Code 113-2A  
Austin, Texas 78714

INTER-AGENCY

**RE: Docket No. 454-13-2493.F; Office of Public Insurance Counsel v. State Farm Lloyds**

Dear Commissioner Rathgeber:

Please find enclosed a Proposal for Decision in this case. It contains our recommendation and underlying rationale.

Exceptions and replies may be filed by any party in accordance with 1 Tex. Admin. Code § 155.507(c), a SOAH rule which may be found at [www.soah.state.tx.us](http://www.soah.state.tx.us).

Sincerely,

A handwritten signature in black ink, appearing to read "Hunter Burkhalter".

Hunter Burkhalter  
Administrative Law Judge

A handwritten signature in black ink, appearing to read "Henry D. Card".

Henry D. Card  
Administrative Law Judge

HB/HDC/mle/lh

Enclosures: includes 1 CD

xc: Amanda Brown, Chief Clerk, Texas Department of Insurance, 333 Guadalupe, Tower 1, 13<sup>th</sup> Floor, Mail Code 113-2A, Austin, Texas 78714 - VIA INTER-AGENCY  
Deeia Beck, Office of Public Insurance Counsel, 333 Guadalupe, Ste. 3-120, Austin, Texas 78701 - VIA INTER-AGENCY  
Susan Conway, Graves Dougherty, Hearon, & Moody, 401 Congress Ave., Ste. 2200, Austin Texas 78701 - VIA REGULAR MAIL

**SOAH DOCKET NO. 454-13-2493.F**

<p><b>OFFICE OF PUBLIC INSURANCE COUNSEL, Petitioner</b></p>	<p>§ § § § § § § § §</p>	<p style="text-align: right;"><b>BEFORE THE STATE OFFICE</b></p> <p style="text-align: center;"><b>OF</b></p> <p style="text-align: right;"><b>ADMINISTRATIVE HEARINGS</b></p>
<p><b>v.</b></p> <p><b>STATE FARM LLOYDS, Respondent</b></p>		

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SOAH DOCKET NO. 454-13-2493.F

OFFICE OF PUBLIC INSURANCE  
COUNSEL,  
Petitioner

v.

STATE FARM LLOYDS,  
Respondent

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BEFORE THE STATE OFFICE

OF

ADMINISTRATIVE HEARINGS

PROPOSAL FOR DECISION

I. INTRODUCTION

The Office of Public Insurance Counsel (OPIC) challenges the Texas homeowners insurance rate currently in effect for State Farm Lloyds (SFL). OPIC contends the rate is excessive, unreasonable, or unfairly discriminatory for the risks to which it applies, as prohibited by Texas Insurance Code (Code) § 2251.052(b).

The Administrative Law Judges (ALJs) find that only one of SFL's expense categories—its requested contingency expense—was shown to be unreasonable or excessive. However, even after subtracting this unreasonable expense, SFL's overall indicated rate remains above the level of the current rate and, therefore, the current rate is not excessive. The current rate was not shown to be otherwise unreasonable or unfairly discriminatory. Therefore, the ALJs conclude that SFL's rate meets the requirements of Chapter 2251 of the Code and should remain in effect.

II. APPLICABLE LAW AND PROCEDURAL HISTORY

SFL filed its rates with the Texas Department of Insurance (TDI or the Department) on September 7, 2012. OPIC filed written objections to those rates.<sup>1</sup> Under the Code, an insurer may use its filed rates unless the Commissioner of Insurance disapproves them. The Commissioner of Insurance reviewed the filing and OPIC's objections and did not disapprove the filing. SFL's new

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<sup>1</sup> OPIC Ex. 1 at 9-11.

rates went into effect for new policies on November 1, 2012, and for renewal policies on December 1, 2012.

In February 2013, OPIC sought a hearing on the rates under Code § 2251.105(d).<sup>2</sup> That section states, “If, after the hearing, the commissioner determines that the filing does not meet the requirement of this chapter,” she “shall issue an order:

- (1) specifying in what respects the filing fails to meet those requirements; and
- (2) stating the date on which the filing is no longer in effect, which must be within a reasonable period after the order date.”

Under the Code, OPIC has the burden of proving the rate is excessive, unreasonable, or unfairly discriminatory.<sup>3</sup> “Excessive” and “unfairly discriminatory” are defined in the Code.<sup>4</sup> The “Rate Standards” section of the Code lists the factors, such as “past and prospective loss experience” and “operating expenses,” to be considered in setting rates.<sup>5</sup> If, after the hearing, the Commissioner were to disapprove the rate, that determination would have only prospective effect. Excess amounts billed from the effective date to the date of disapproval would not be refunded.

There are secondary legal authorities that may be referred to in order to determine whether rates are excessive, unreasonable, or unfairly discriminatory. The Casualty Actuarial Society (CAS) has adopted a Statement of Principles Regarding Property and Casualty Insurance Ratemaking (CAS Ratemaking Principles) which is recognized as authoritative on the ratemaking issues. Additionally, the Actuarial Standards Board (ASB) has adopted Actuarial Standards of Practice (ASOPs) which, among other things, address the ratemaking considerations and are customarily used for guidance in Texas ratemaking proceedings.<sup>6</sup>

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<sup>2</sup> OPIC Ex. 1 at 3-7.

<sup>3</sup> Tex. Ins. Code (Code) § 2251.105; Tr. at 27-28.

<sup>4</sup> Code § 2251.051. The Code does not define “unreasonable.”

<sup>5</sup> Code § 2251.052(a).

<sup>6</sup> Tr. at 118.

Both parties to the case also cited and discussed at considerable length Commissioner Mike Geeslin's 2009 SFL rate order (Geeslin Order) in support of various portions of their arguments.<sup>7</sup> That Order stemmed from a rate case that began in 2003. Under a now-expired statute, then-Commissioner José Montemayor held a hearing September 2-3, 2003, and ordered SFL to reduce its filed rate by 12% effective September 7, 2003. SFL appealed and kept charging the disputed rates. The Court of Appeals reversed the 2003 Order in 2008, and remanded.<sup>8</sup>

At the time of the remand, the 2003 rates were no longer in effect, but they had been in effect until July 31, 2008. They had remained in effect for such a long time because the Insurance Commissioner twice had placed SFL under rate supervision, revoking SFL's ability to file and use new rates without prior approval. Both supervision orders eventually were reversed on appeal.<sup>9</sup>

SFL filed for a rate increase in May of 2006. Eventually that filing led to an agreed-upon 2.8% increase effective in 2008. Since that time, SFL has made rate filings that the Commissioner has not disapproved and that have gone into effect.

In the 2009 remand that led to the Geeslin Order, SFL, TDI, and OPIC litigated the issue of what rates should have been effect from September 7, 2003, through July 31, 2008, and whether refunds for that period should be ordered. In the Geeslin Order, Commissioner Geeslin ordered refunds based on his finding that a 6.2% rate reduction was appropriate for 2003-04 and 3.4% reduction was appropriate for 2004-08.<sup>10</sup>

The parties' arguments about the precedential or persuasive effects of the Geeslin Order are discussed, as appropriate, in the various subsections of this Proposal for Decision.

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<sup>7</sup> Commissioner's Order in TDI Docket No. 2562-A, issued November 16, 2009 (Geeslin Order).

<sup>8</sup> *Geeslin v. State Farm Lloyd's*, 255 S.W. 3d 786 (Tex. App.—Austin 2008, no pet.).

<sup>9</sup> *Texas Dep't of Insurance v. State Farm Lloyd's*, 260 S.W.3d 233 (Tex. App.—Austin 2008, no pet.); *State Farm Lloyd's v. Geeslin*, 267 S.W.3d 438 (Tex. App.—Austin 2008, no pet.).

<sup>10</sup> Geeslin Order at 1-2, 123-24, 130. See Tr. at 17, 20.

After timely notice was sent to the parties, the hearing in this case was convened before ALJs Hunter Burkhalter and Henry D. Card on April 24, 2013, at the State Office of Administrative Hearings (SOAH).

OPIC presented the testimony of one witness, Allan I. Schwartz. Mr. Schwartz is the president of an actuarial consulting firm and has worked on insurance ratemaking issues in Texas for more than 20 years.

SFL presented the testimony of three witnesses, Dr. David Appel, Sara Frankowiak, and Robert J. Kelley. Dr. Appel works as a consultant on economic and actuarial issues. He has authored a number of publications on insurance issues and has regularly provided testimony in insurance ratemaking cases in Texas. Ms. Frankowiak is an actuary who works as a Pricing Manager for State Farm Automobile Insurance Company (State Farm Mutual). She is responsible for managing pricing for homeowners and other lines of insurance in six states, including Texas. Mr. Kelley is an actuary employed as the Assistant Vice President and Actuary in the Property and Casualty Department at State Farm Mutual. Along with Ms. Frankowiak, he had primary responsibility for preparing SFL's filing at issue in this case.

The hearing was adjourned on April 26, 2013. OPIC's reply brief was filed on June 20, 2013, on which date the record closed.

### III. RATE-SETTING ISSUES

SFL's rate filing indicated that its data supported an average premium per policy of \$1,794. However, its filed rate currently in effect is \$1,579 average premium per policy, which is a difference of \$215. Thus, for OPIC to prove that the rate in effect is excessive, it must show that SFL's indicated rate is excessive by more than \$215. In other words, in order for OPIC to prevail, the preponderance of the credible evidence must demonstrate that the average premium per policy should be less than \$1,579.

Attached to this PFD as Attachment A is a chart that shows the dollar differences between SFL's indicated rate and OPIC's indicated rate for each homeowners insurance expense category.<sup>11</sup> The two largest differences between the parties are in the non-hurricane catastrophe and loss adjustment expense (LAE) and the underwriting profit categories. For the non-hurricane catastrophe and LAE category, SFL's projected cost, per policy, is \$449, while OPIC's projected cost is \$329, a difference of \$120.<sup>12</sup> For the underwriting profit category, the difference between the two parties is \$228.

Changes to individual cost categories would also flow through to affect underwriting profit, contingency, and variable expenses—components that are themselves percentages of premiums. For example, according to SFL, if only OPIC's non-hurricane catastrophe and LAE loss figures were adopted, with no other changes to SFL's indications, the overall reduction after the flow-throughs would be \$188.<sup>13</sup>

For the rate to be found excessive, OPIC must prevail on at least one of the two major issues. The parties' disagreements on the other expenses involve smaller dollar amounts that, collectively, do not add up to \$215 even when flow-through costs are considered. Two cost categories, hurricane losses and SFL's variable expense percentage, were undisputed. The disputed individual rate-setting categories are discussed below.

#### **A. Non-Hurricane Catastrophe Losses and LAE**

A "catastrophe" is defined by the ASOPs as "a relatively infrequent event or phenomenon that produces unusually large aggregate losses."<sup>14</sup> Non-hurricane catastrophes include such phenomena as hailstorms, tornados, and wildfires.

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<sup>11</sup> The source of Attachment A is SFL Ex. 2 (Kelley Direct) at 336.

<sup>12</sup> The numbers are rounded.

<sup>13</sup> SFL's Post-Hearing Brief at 33.

<sup>14</sup> ASOP 39, § 2.1, p. 2, quoted in SFL Ex. 2 (Kelley Direct) at 16.

In its filing, SFL used countrywide State Farm company data to derive a 2% per year upward trend in non-hurricane catastrophe and LAE expenses per Amount of Insurance Year (AIY).<sup>15</sup> It then applied that trend to Texas historical average non-hurricane catastrophe and LAE/AIY. OPIC disagreed with that approach. OPIC contended that the Texas-only data were sufficiently credible and should be used, that the Texas trend line was not statistically different from a flat line, and therefore a 0% trend should be used. As mentioned above, the difference per policy, before any flow-throughs to other expense categories, is \$120.

OPIC and SFL agreed that Texas is a large, particularly catastrophe-prone state.<sup>16</sup> SFL disagreed with OPIC's use of the Texas-only data for trending, however, because of that data's volatility and, therefore, its lack of credibility for predictive purposes. SFL also disputed OPIC's contention that the Texas-only data would yield a trend of 0%. SFL witness Appel testified that the Texas-only data show a trend of 1.1%.

The ALJs find that SFL properly considered data from outside Texas and properly applied the resulting 2% trend to the non-hurricane catastrophe losses and LAE. No adjustment should be made to that expense category. If, in the alternative, the Commissioner finds that Texas-only data should be used, the actual Texas-only trend of 1.1% should be applied.

### **1. Parties' Evidence and Arguments**

SFL's method of calculating non-hurricane catastrophe and LAE costs is set out in its Texas rate filing. As State Farm does in other jurisdictions, SFL used state-specific catastrophe data, excluding hurricane data, then applied a trend factor "based on companywide Homeowners data since individual state data lacks credibility."<sup>17</sup> That trend factor in this filing was 2%.

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<sup>15</sup> SFL Ex. 3 (Frankowiak Direct) at 18-19; SFL Ex. 1 at 203-04, 207-08. The countrywide data used for trending included Texas data.

<sup>16</sup> SFL Ex. 2 (Kelley Direct) at 17; OPIC Ex. 4 (Schwartz Rebuttal) at 24.

<sup>17</sup> SFL Ex. 1 at 203.

OPIC witness Schwartz described SFL's trend factor as "unsupported" because it reflected experience outside of Texas as well as the experience of companies other than SFL. Mr. Schwartz cited Texas Insurance Code § 2251.052, which states in part:

**RATE STANDARDS.**

(a) In setting rates, an insurer shall consider:

(1) past and prospective loss experience:

(A) inside this state; and

(B) outside this state if the data from this state are not credible;

Mr. Schwartz did not dispute that the countrywide trend was 2%. He testified that SFL has sufficient Texas experience to be credible, however, and that the Texas-only data therefore should be used. He further testified that a graph of Texas catastrophe experience shows a random pattern with no statistically significant trend.<sup>18</sup>

Mr. Schwartz testified that statistical measures such as R-squared and the T-statistic confirmed that the Texas data show no reliable trend. He stated that the R-squared value over the entire time was 3%. According to Mr. Schwartz, an R-squared of 100% would show a perfect correspondence between the observed data and the trend line. The T-statistic value was 1.0, which, according to Mr. Schwartz, showed that the trend line was not statistically different from a flat line. Based on his analysis of the Texas-only data, Mr. Schwartz testified that no cost growth trend (0%) should be applied to SFL's non-hurricane catastrophe and LAE expenses.

SFL witness Sara Frankowiak noted that Texas, because of its geographic location, size, and diversity, has significant exposure to more kinds of catastrophe risk than any other state in the United States. She observed, as had Mr. Schwartz, that the historical catastrophe data for Texas can and often do vary significantly from year to year. She testified that individual state data lack credibility; therefore, the State Farm countrywide data appropriately were used to calculate the catastrophe trend.

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<sup>18</sup> OPIC Ex. 3 (Schwartz Direct) at 15-17. The graph of Texas experience is on page 16.

Ms. Frankowiak observed that Mr. Schwartz had cited only a portion of Texas Insurance Code § 2251.052. She noted that the subsection partially quoted by Mr. Schwartz lists eight factors to be considered. An insurer is also required to consider:

- (8) any other factors inside and outside this state:
  - (A) determined to be relevant by the insurer; and
  - (B) not disallowed by the commissioner.<sup>19</sup>

Ms. Frankowiak disagreed with Mr. Schwartz's assertion that the Texas-only data were "credible." She testified that "credibility," in the insurance ratemaking context, is a measure of the predictive value that an actuary attaches to a particular body of data.<sup>20</sup> She pointed out that the Texas data were far too volatile to have predictive value, and that credibility is increased by making data groupings more homogenous or by increasing the size of the group analyzed,<sup>21</sup> as SFL did by using countrywide data. Ms. Frankowiak stated that, with more volatile data, a large event in a recent year could cause the trend slope to be much higher than anticipated, while a large event in an older year could cause the slope to flatten. As an exhibit to her testimony, Ms. Frankowiak supplied a graphic comparison of the Texas-only versus the countrywide data trends.<sup>22</sup>

SFL did fit a trend line to the SFL Texas-only catastrophe data from 1980 through 2011 and from 1981 through 2011. Both showed a trend of 1.1%, rather than the 0% proposed by Mr. Schwartz.

Finally, Ms. Frankowiak testified that it makes sense that there would be an upward trend in non-hurricane catastrophe loss expenses. SFL's definition of a "catastrophe," which it has used for many years, is an event that results in over \$500,000 in losses and 500 claims. Ms. Frankowiak

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<sup>19</sup> Tex. Ins. Code § 2251.052(a)(8).

<sup>20</sup> Under the ASOPs, "credibility" is defined as "a measure of the predictive value in a given application that the actuary attaches to particular body of data (*predictive* is used here in the statistical sense and not in the sense of predicting the future)." (Italicization in original.) ASOP 25, § 2.1, p. 2, quoted in SFL Ex. 2 (Kelley Direct) at 212.

<sup>21</sup> ASOP 25, § 2.2, p. 2, quoted in SFL Ex. 3 (Frankowiak Direct) at 25.

<sup>22</sup> SFL Ex. 3 (Frankowiak Direct) at 65.

observed that, as the costs of labor and building materials increase, more events would exceed that threshold. Also, urbanization would increase the likelihood of an event causing 500 or more claims.

Dr. Appel also took issue with Mr. Schwartz's use of Texas-only data to apply a 0% trend for non-hurricane CAT losses and LAE. Dr. Appel first testified that SFL's trends were not "unsupported," as Mr. Schwartz contended. Instead, SFL provided the underlying data and the results, which could easily be replicated.

Dr. Appel disagreed with Mr. Schwartz's characterization and use of the R-squared and T-statistic.<sup>23</sup> Dr. Appel described R-squared as a measure of the variability of the data around a trend line; it is defined as the percentage of the variation in the data that is "explained" by that trend line. According to Dr. Appel, R-squared is not the statistic by which to judge whether a trend itself is reliable.

Dr. Appel agreed with Mr. Schwartz that the Texas-only data are quite variable. Nevertheless, he pointed out that there is a reliable trend in that data. Over the 1980-2011 period, the trend line indicated that Texas non-hurricane losses were increasing at an annual rate of approximately 1.1%.

Dr. Appel described the T-statistic as a statistic one can use to test the probability that an observed trend is really a trend, as opposed to random noise. According to Dr. Appel, a T-statistic of 1.0 means there is approximately an 84% chance that there actually is a trend in the data and about a 16% chance that the "trend" is really just random variation. A higher T-statistic would give greater assurance of an actual trend. For example, a T-statistic of 1.68 would offer an approximately 95% assurance of an actual trend. Dr. Appel agreed that the T-statistic is a reasonable one to use in evaluating the statistical quality of an apparent trend in data, but did not agree with Mr. Schwartz's conclusion that the Texas data showed a 0% trend.<sup>24</sup>

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<sup>23</sup> At the hearing, Dr. Appel discussed the meaning of R-squared and the T-statistic in some detail. Tr. at 530-45.

<sup>24</sup> Tr. at 542-46.

Dr. Appel offered two other trends that he believed confirmed SFL's conclusion that non-hurricane loss expenses are increasing. For Texas data from 1997-2011, he calculated an annual trend of 2.8%. He also presented worldwide data showing an annual increase in worldwide disasters at an annual rate of 3.6% since 1970.<sup>25</sup>

In summary, Dr. Appel agreed with SFL's use of countrywide data, as opposed to Texas-only data, because they are less volatile and more reliable. If Texas-only data were used, however, he testified those data show a trend of 1.1%, rather than the 0% used by Mr. Schwartz.

Mr. Schwartz, in rebuttal, reemphasized the unusual nature of catastrophe risk in Texas. In Mr. Schwartz's opinion, because of the many different types of catastrophes in Texas, the expected variability of non-hurricane catastrophe losses is less in Texas on a relative basis than for other states: the occurrence of one type of catastrophe can be offset by the absence of another. Mr. Schwartz analyzed annual trends in Texas-only and countrywide data over decreasing periods of years. He determined that the standard deviation of the Texas annual loss trend over various time periods is only slightly higher than the countrywide value—0.8% in Texas versus 0.4% countrywide. Mr. Schwartz testified that Texas's large geographic area, combined with its large spread of risk across various non-hurricane catastrophe events, allow Texas's non-hurricane catastrophe experience to be credible and reliable.<sup>26</sup>

Mr. Schwartz also cited an internal State Farm memorandum that calculated non-hurricane catastrophe trends for a 20-year period. That calculation showed a trend for the Gulf Region, including Texas, of -0.1%. Neither OPIC nor SFL advocated using a 20-year period for trend calculation, however, nor did the memorandum advocate using the indicated state trends in rate filings.<sup>27</sup>

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<sup>25</sup> SFL Ex. 4 (Appel Direct) at 37-39. Dr. Appel did not suggest that either of those trends be used.

<sup>26</sup> OPIC Ex. 4 (Schwartz Rebuttal) at 24-26.

<sup>27</sup> OPIC Ex. 4 (Schwartz Rebuttal) at 27-28.

Mr. Schwartz disagreed with Dr. Appel's critique of his use of statistical measures. Mr. Schwartz testified that R-squared and the T-statistic are both valid measures to use in determining whether the passage of time (as measured by the year) helps to explain movements in the Texas non-hurricane catastrophe and LAE/AIY ratio.

In his rebuttal testimony at the hearing, Mr. Schwartz presented additional testimony regarding the frequency of non-hurricane catastrophe events in Texas. Mr. Schwartz testified that the number of non-hurricane catastrophe events trended downward in Texas in the period of 1991-2011. That information did not address the severity of those events, however. At the hearing, Mr. Schwartz ultimately agreed with Dr. Appel's observation that the Texas trend data from 1980 to 2011 show a trend of 1.1%.<sup>28</sup>

Ms. Frankowiak, in her live testimony, addressed Mr. Schwartz's discussion of the standard deviation of Texas versus countrywide non-hurricane catastrophe loss data. Ms. Frankowiak observed that in order to compare standard deviations of two different data sets, one must look at the standard deviation in relation to the mean of the data. For companywide data, the standard deviation was 0.5% and the mean was 2.6%, for a coefficient of variation of 0.2. For the Texas-only data, the standard deviation was 0.8% and the mean was 0.7%, for a coefficient of variation of 1.14. Ms. Frankowiak stated that the difference in the coefficients of variation showed the relative volatility of the Texas-only data, thus proving that the Texas-only data lack credibility.<sup>29</sup>

## 2. ALJs' Analysis

The evidence does not support OPIC's recommended 0% trend for non-hurricane catastrophe losses and LAE. As stated earlier, Texas Insurance Code § 2251.052 states in part:

- (a) In setting rates, an insurer shall consider:
  - (1) past and prospective loss experience:

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<sup>28</sup> "Q. So if you fit a trend line to your Texas data, you actually get a positive line, not a zero line. A. You get 1.1 percent; I'm not denying that." Tr. at 134.

<sup>29</sup> Ms. Frankowiak determined the coefficient of variation by dividing the standard of deviation by the mean. Tr. at 414.

- (A) inside this state; and
- (B) outside this state if the data from this state are not credible;

- .....
- (8) any other factors inside and outside this state:
    - (A) determined to be relevant by the insurer; and
    - (B) not disallowed by the commissioner.

In this context, “credibility” refers not to the accuracy of the data, but to its predictive value.<sup>30</sup>

Although Mr. Schwartz contended the Texas-only data were credible, he also stated that the graph of Texas-only experience “clearly shows a random pattern with no statistically significant trend.” He performed two statistical measures that he believed showed no reliable trend. Mr. Schwartz’s testimony was internally inconsistent, however. SFL showed, and Mr. Schwartz agreed, that the Texas-only data showed an actual trend of 1.1%. Mr. Schwartz chose not to use that trend, because he believed it did not have reliable predictive value. In other words, Mr. Schwartz’s 0% trend recommendation was based on the belief that the data were not credible for the purposes of prediction. If the data were, in fact, credible, Mr. Schwarz should have used the indicated trend of 1.1%, rather than a 0% trend.

OPIC’s assertion that the Texas-only data were credible was undermined by the wide variation in the data and by OPIC’s failure to use the 1.1% trend shown by that data. The ALJs find that the Texas-only data were not credible—*i.e.*, they did not have reliable predictive value. Thus, they should not be used to determine the presence and magnitude of a trend. SFL properly considered data from outside the state in determining the trend to be applied to non-hurricane catastrophe losses and LAE. The ALJs find that no adjustment should be made to that expense category.

If the Commissioner finds that the Texas-only data were a credible source from which to determine the presence of a trend, OPIC’s 0% trend still should not be applied to the non-hurricane catastrophe losses and LAE. In that event, the actual 1.1% trend shown by that data should be

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<sup>30</sup> ASOP 25, § 2, l. p. 2, quoted in SFL Ex. 2 (Kelley Direct) at 212.

applied. Presumably such an adjustment would lower the non-hurricane catastrophe loss and LAE expense by approximately \$66, rather than the \$120 recommended by OPIC.<sup>31</sup>

## **B. SFL's Use of Reinsurance**

Strictly speaking, SFL's utilization of reinsurance was not directly taken into account when it calculated its rate in the filing. However, because SFL's costs of purchasing reinsurance were indirectly considered by the company when it calculated the underwriting profit provision in the filing, it is necessary to discuss and understand SFL's use of reinsurance. Moreover, because OPIC implies that the amount of reinsurance costs that SFL included in the filing may be overstated, it is necessary to evaluate the reasonableness of SFL's projected reinsurance expenses. The relevance of this reinsurance discussion will become clearer after reading Section III.D. of this PFD (addressing SFL's Underwriting Profit).

Reinsurance is insurance coverage purchased by one insurance company from another insurance company.<sup>32</sup> In order to ensure that it has the financial ability to pay any claims made against it by its policyholders, an insurer may keep an adequate supply of cash on hand; or, alternatively, the insurer could buy reinsurance. Reinsurance is often purchased in order to cover catastrophe losses if the insurer does not wish to retain the risks associated with the catastrophes.<sup>33</sup> In most years, an insurer should be able to pay all claims with the premiums it collects in that year. In some years, however, there may be one or more large, unusual catastrophes (such as a hurricane) that will cause policyholders' claims to far outstrip the premiums collected by the insurer. In order to protect against this contingency, the insurer must either maintain a large, but rarely needed, surplus of cash or buy reinsurance. If, for example, an insurer calculated that it needed to have access to \$5 billion in order to pay all claims in the event of catastrophic losses, it could: (1) choose to amass and maintain a cash surplus of \$5 billion; (2) purchase \$5 billion worth of reinsurance coverage; or (3) amass a cash surplus of a portion of the \$5 billion and purchase reinsurance for the

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<sup>31</sup> The effect of substituting a 1.1% trend for the 2% trend was not in the record.

<sup>32</sup> OPIC Ex. 3 (Schwartz Direct) at 25.

<sup>33</sup> OPIC Ex. 3 (Schwartz Direct) at 25.

remainder.<sup>34</sup> SFL utilizes the third approach, building up its cash surplus while also “renting” surplus capital from reinsurers.<sup>35</sup>

During the time period relevant to its filing, SFL had in force three primary reinsurance contracts (which it refers to as “reinsurance treaties”):

- (1) The Texas Catastrophe Excess of Loss reinsurance treaty (Cat Occurrence Treaty), which provides reinsurance coverage for individual catastrophic events. Pursuant to this treaty, SFL bears the full risk of the first \$200 million of catastrophe losses; the next \$800 million above \$200 million is 100% reinsured by State Farm Mutual; the next \$3.2 billion above that is reinsured by a group of Lloyds syndicates and State Farm Mutual; and SFL bears the full risk for losses above \$4.2 billion.
- (2) The Texas Catastrophe Aggregate Excess of Loss reinsurance treaty (Cat Aggregate Treaty), pursuant to which State Farm Mutual provides reinsurance with an aggregate limit of \$500 million in excess of an aggregate SFL retention of \$250 million.
- (3) The Texas Wildfire Aggregate Excess of Loss Reinsurance Treaty (Wildfire Treaty), pursuant to which State Farm Mutual provides up to \$300 million in reinsurance protection for wildfire events in excess of SFL’s retained risk of \$50 million.<sup>36</sup>

SFL also purchases other forms of reinsurance, but the costs associated with them are not significant.<sup>37</sup> In calculating its rates in its filing, SFL took into account its net cost of reinsurance associated with the Cat Occurrence Treaty and the Cat Aggregate Treaty. It did not include the reinsurance costs of the Wildfire Treaty or its other small reinsurance costs because it deemed the costs of those treaties to be negligible.<sup>38</sup> In its filing, SFL asserted that, from July 1, 2012, to

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<sup>34</sup> See Tr. at 494; SFL Brief at 80-81.

<sup>35</sup> SFL Brief at 57.

<sup>36</sup> SFL Ex. 2 (Kelley Direct) at 12-13; Tr. at 332-33.

<sup>37</sup> SFL Ex. 2 (Kelley Direct) at 14.

<sup>38</sup> SFL Ex. 2 (Kelley Direct) at 13-14.

June 30, 2013, it would spend \$347 million on the Cat Occurrence Treaty and the Cat Aggregate Treaty, and its net reinsurance costs would equate to roughly 10% of premium.<sup>39</sup>

OPIC asserts that the filing provides an inaccurate picture of SFL's actual reinsurance costs going forward. Mr. Schwartz reviewed SFL's annual financial statements for 2010 and 2011 and determined that the company spent an annual average of \$244.3 million per year in those two years. This average is roughly \$102 million, or 42%, lower than the amount SFL included in its filing.<sup>40</sup> Mr. Schwartz faults SFL for failing to explain, in its filing, why its reinsurance costs would increase so dramatically from 2011 to 2012. According to Mr. Schwartz, SFL has failed to show why the larger amount identified in the filing is reasonable.<sup>41</sup> Mr. Schwartz conceded, however, that in calendar year 2012, as shown on the company's annual financial statements, SFL paid roughly \$342 million for reinsurance.<sup>42</sup>

SFL responds by arguing that it is "meaningless" to compare the amount it paid for reinsurance in 2010 and 2011 to the amount it expects to pay going forward. As explained by Mr. Kelley, the company's 2010 and 2011 reinsurance costs were paid pursuant to reinsurance contracts that are no longer in effect. According to Mr. Kelley, the key to ratemaking is to include estimates of future, not past, costs. Thus, SFL relied upon its most recent, actual reinsurance costs for the period from July 2012 to June 2013 because it concluded that those costs more accurately reflect future costs than do those it paid in 2010 and 2011.<sup>43</sup> Mr. Kelley further explained that, due to updated hurricane modeling, its hurricane loss estimates have been increased, and this fact was the primary driver in the increase in reinsurance costs from 2011 to 2012 and going forward. Another significant driver of the increase was SFL's decision to increase its level of reinsurance by reducing its own level of risk retention in the Cat Aggregate Treaty from \$400 million to \$250 million.<sup>44</sup> Mr. Kelley expressed his confidence in the accuracy of the filing's \$347 million estimate of

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<sup>39</sup> SFL Ex. 2 (Kelley Direct) at 13; SFL Ex. 1 (Filing) at 247; Tr. at 306-08.

<sup>40</sup> OPIC Ex. 3 (Schwartz Direct) at 25-26; Tr. at 78-79.

<sup>41</sup> Tr. at 79.

<sup>42</sup> Tr. at 146-47.

<sup>43</sup> SFL Ex. 2 (Kelley Direct) at 18-19.

<sup>44</sup> SFL Ex. 2 (Kelley Direct) at 19; Tr. at 334-36.

reinsurance costs because it was simply based upon the most recent reinsurance contracts executed by SFL.<sup>45</sup>

Mr. Schwartz also argued that SFL's decision to retain less risk (by holding a smaller surplus) and purchase more reinsurance runs counter to "a common practice of insurance companies retaining more of the risk and making less use of reinsurance."<sup>46</sup> He appears to have based that conclusion on the following statement within a publication by Willis Re, a reinsurance broker: "The overall volume of reinsurance premium coming into the global market is being squeezed by a combination of M&A activity and higher retentions by larger insurers."<sup>47</sup> On cross examination, however, Mr. Schwartz conceded that, even if there has been a trend of reducing reinsurance among larger insurers of all lines of insurance on a global basis, there could still be a trend of increasing reinsurance among single line homeowners insurers in catastrophe-prone states like Texas.<sup>48</sup> Mr. Schwartz also conceded that national statistical data offered by SFL indicated that, from 2002 to 2012, the amount of premiums collected for homeowners insurance in the United States grew by roughly 67%, while the use of reinsurance to cover those homeowners policies grew by roughly 300%.<sup>49</sup> Dr. Appel also testified that the nationwide trend has been for homeowners insurers to increasingly rely upon reinsurance.<sup>50</sup>

Mr. Schwartz and OPIC are also critical of the fact that SFL purchases the "vast majority" of its reinsurance from its affiliated companies, primarily State Farm Mutual. According to Mr. Schwartz, in 2010 and 2011, SFL purchased 82.5% of its reinsurance from affiliates, and this trend seems to be increasing. Mr. Schwartz opines that SFL's reinsurance transactions are "simply a shifting of expected profit from SFL to an affiliated insurance company."<sup>51</sup> He also accuses SFL's primary reinsurer, State Farm Mutual, of making unreasonably large profits off of its reinsurance

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<sup>45</sup> Tr. at 330.

<sup>46</sup> OPIC Ex. 4 (Schwartz Rebuttal) at 59-60.

<sup>47</sup> OPIC Ex. 10 at 3; *see also* Tr. at 597-98.

<sup>48</sup> Tr. at 559-600.

<sup>49</sup> Tr. at 167-68; SFL Ex. 6.

<sup>50</sup> Tr. at 555-56.

<sup>51</sup> OPIC Ex. 3 (Schwartz Direct) at 27.

contracts with SFL.<sup>52</sup> For these reasons, Mr. Schwartz concludes that SFL has failed to prove that its reinsurance costs are reasonable.<sup>53</sup> On cross examination, Mr. Schwartz admitted that he had no evidence to demonstrate that State Farm Mutual charged more than the market rate when it sold reinsurance to SFL.<sup>54</sup>

SFL responds by disputing the notion that some of the profits earned by its reinsurers “should somehow be attributed back to SFL.” According to Mr. Kelley, SFL and State Farm Mutual (SFL’s primary reinsurer) are two separate and distinct companies, and the reinsurance contracts between them were arms-length deals. Mr. Kelley explains that State Farm Mutual is not lending its capital to SFL free of charge. Rather, by agreeing to serve as an SFL reinsurer, it takes on binding legal obligations and assumes substantial risk, for which it is entitled to a fair profit. Dr. Appel pointed out that State Farm Mutual has, in recent years, been forced to pay claims on its reinsurance with SFL in amounts far greater than the premiums it collected from SFL.<sup>55</sup>

Perhaps most importantly, SFL contends that it has routinely purchased reinsurance from State Farm Mutual at a lower cost than SFL pays for reinsurance from unaffiliated companies. According to Mr. Kelley, the reinsurance the company purchases from State Farm Mutual is roughly 10% cheaper than the reinsurance it purchases from a consortium of other reinsurers. Since 2009, State Farm Mutual has consistently charged SFL below-market rates for its reinsurance.<sup>56</sup> Along the same lines, Dr. Appel conducted a study to estimate the fair market cost of SFL’s reinsurance by analyzing information from capital markets to infer the risk premiums investors demand for assuming catastrophe insurance exposure. Using this data, Dr. Appel calculated that the fair market value for the reinsurance purchased by SFL is \$395 million, which is 14% higher than the \$347 million estimate included in SFL’s filing.<sup>57</sup> Thus, in this regard, Dr. Appel considers the reinsurance SFL purchases from State Farm Mutual to be “extremely favorable” to Texas

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<sup>52</sup> OPIC Ex. 4 (Schwartz Rebuttal) at 60-61.

<sup>53</sup> OPIC Ex. 3 (Schwartz Direct) at 27.

<sup>54</sup> Tr. at 169-73.

<sup>55</sup> Tr. at 554.

<sup>56</sup> Tr. at 341-42.

<sup>57</sup> SFL Ex. 4 (Appel Direct) at 22-27.

policyholders.<sup>58</sup> Mr. Kelley also pointed out that SFL is obligated to seek and obtain the Department's prior approval of its reinsurance contracts with affiliated companies.<sup>59</sup> SFL did so with the reinsurance contracts with its affiliates, thereby indicating that the Department does not believe those contracts are inappropriate or unfair to SFL's policyholders.<sup>60</sup>

The ALJs conclude OPIC failed to prove that SFL's projected reinsurance costs of \$347 million are unreasonable. Although the amount represents a significant cost increase over previous years, SFL demonstrated that the projections reflect the actual costs of some (but not all) of SFL's existing and ongoing reinsurance contracts. Mr. Kelley convincingly explained the driving forces behind the cost increases. Moreover, SFL demonstrated that its recent practice of increasing reliance upon reinsurance is consistent with industry trends. Mr. Schwartz's reliance upon SFL's past reinsurance costs from 2010 and 2011 was not appropriate because it proved to be outdated in relation to newer reinsurance contracts negotiated by the company.

Mr. Schwartz provided no evidence to demonstrate that State Farm Mutual charged above-market rates to SFL. SFL convincingly demonstrated, on the other hand, that the reinsurance rates it pays to State Farm Mutual are roughly 10% to 14% below market rates, thus benefitting SFL's policyholders. In Docket 09-0927, Mr. Schwartz made essentially the same argument that he made in the present case: that "the costs of reinsurance should not be included [in SFL's rates] because the reinsurer is an affiliate company." In that case, Commissioner Geeslin concluded that such an argument would have merit only "if there were any evidence that the premiums [the reinsurer] charged SFL were above market rates." Because there was no such evidence, Commissioner Geeslin rejected Mr. Schwartz's argument.<sup>61</sup> For the same reasons, the ALJs do so in the present case.

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<sup>58</sup> SFL Ex. 4 (Appel Direct) at 21-22.

<sup>59</sup> SFL Ex. 2 (Kelley Direct) at 20-22; *see also* Code § 823.104 and 28 Tex. Admin. Code § 7.204(b).

<sup>60</sup> SFL Ex. 2 (Kelley Direct) at 20-22; Tr. at 342.

<sup>61</sup> Geeslin Order at 46.

As noted above, in its filing SFL estimated its annual reinsurance costs will equal \$347 million, and its net reinsurance costs will equal 10% of premium.<sup>62</sup> For the foregoing reasons, the ALJs conclude that these estimates are reasonable.

### C. The Unusually High Level of Risks Faced by SFL

As with the discussion of reinsurance, the issue of the level of risk faced by SFL was not directly taken into account when it calculated its rate in the filing. However, because SFL's risk level was indirectly considered by the company when it calculated the underwriting profit provision in the filing, it is necessary to discuss and understand the risks faced by SFL. Moreover, because OPIC suggests, to some extent, that SFL is overstating the level of risk that it faces, it is necessary to evaluate the reasonableness of SFL's arguments regarding its risks. Like the discussion on reinsurance, the relevance of this discussion of risks will become clearer after reading Section III.D. of this PFD (addressing SFL's Underwriting Profit).

An insurance rate must permit the insurer to earn a reasonable rate of return on its investment, and that return "should be commensurate with returns on investments in other enterprises having corresponding risks."<sup>63</sup> Similarly, ASOP 30 directs actuaries, when setting rates, to "consider the relationship between risk and return."<sup>64</sup> In the present case, SFL contends that there are three factors that make the company subject to unusually high risks and, as a result, its underwriting profit should be increased to reflect that elevated risk. Those three factors are discussed as follows.

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<sup>62</sup> SFL Ex. 2 (Kelley Direct) at 13, SFL Ex. 1 (Filing) at 247; SFL Ex. 4 (Appel Direct) at 84.

<sup>63</sup> Geeslin Order at 61 (*quoting Duquesne Light Co. v. Barasch*, 488 U.S. 299, 307 (1989)).

<sup>64</sup> SFL Ex. 2 (Kelley Direct) at 245.

1. **SFL is a Single-Line Insurer, in a Single, Catastrophe-Prone State**<sup>65</sup>

In Docket 09-0927, Commissioner Geeslin found that SFL faced elevated the risks due to the fact that the company issues almost exclusively homeowners policies in a single state, and that the coverage it provides includes catastrophe coverage in a catastrophe-prone state, thereby justifying a higher underwriting profit for the company.<sup>66</sup> SFL contends that these facts remain true today.

According to SFL witness Robert Kelley, as an issuer of homeowners insurance in Texas, the company is subject to a higher level of risk than the national average. There are several reasons for this elevated risk. Catastrophic events, such as hurricanes, tornados, hail storms, wind storms, and fires, are generally more common in Texas than elsewhere. At the same time, although more frequent in Texas, the frequency of these types of events varies from year to year, and the severity of individual catastrophes is quite variable, “with the potential for devastatingly large losses from a single event.” Thus, according to Mr. Kelley, the “volatility of these losses increases the riskiness of [SFL] providing Texas Homeowners insurance.”<sup>67</sup> SFL points to the year 2011 as an illustration of the riskiness of its business in Texas. In that year, the company incurred losses from 19 separate catastrophe events, with losses totaling more than \$700 million. This total amount is made even more remarkable by the fact that there were no hurricane catastrophes in the state that year.<sup>68</sup> According to Dr. Appel: “[T]here’s almost no argument amongst professionals of insurance . . . that homeowners insurance written in catastrophe-prone jurisdictions like Texas is, if not the riskiest, then amongst the riskiest activities in which insurers are engaged.”<sup>69</sup>

Moreover, Dr. Appel explained that catastrophe losses are quite volatile, resulting in “highly variable” income for SFL over time. For example, the company’s cumulative post-tax income was negative \$1.3 billion from 2000-02, positive \$1.1 billion from 2003-07, and negative \$67 million

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<sup>65</sup> Technically speaking, SFL is almost, but not completely, a single-line insurer. Although roughly 94% of its premiums come from homeowners insurance, it does get a small amount of revenue from other insurance lines. Tr. at 492.

<sup>66</sup> Geeslin Order at Finding of Fact (FOF) 148.

<sup>67</sup> SFL Ex. 2 (Kelley Direct) at 31-32.

<sup>68</sup> SFL Brief at 60; SFL Ex. 3 (Frankowiak Direct) at 17.

<sup>69</sup> Tr. at 527.

from 2008-12.<sup>70</sup> According to Dr. Appel, “there have been years when [SFL] has earned reasonable returns, but other times when the losses have been staggering.”<sup>71</sup> As a result, Dr. Appel testified that the returns earned by the company over the 16 years it has been in business have been “severely inadequate.”<sup>72</sup> Moreover, because SFL operates only in Texas, the risks the company faces in Texas cannot be offset by financial gains in other states.<sup>73</sup>

On behalf of OPIC, Mr. Schwartz responded by contending that SFL should not be rewarded (in the form of a higher underwriting profit) for choosing to structure itself as a stand-alone Texas-only homeowners insurer. Mr. Schwartz pointed out that the larger family of State Farm companies (of which SFL is a part) issues insurance in all 50 states and for many lines of insurance. According to Ms. Schwartz, if the Texas homeowners insurance business was not isolated in SFL, but was instead contained as a part of a larger, nationwide company, then the risks would be lessened.<sup>74</sup>

SFL argues that Mr. Schwartz’s position is contrary to Texas law. SFL points out that it is a standalone company and, under the mandates of the Code, it is entitled to have its rates judged irrespective of its related companies in other states.<sup>75</sup> The ALJs agree with SFL on this point and reject Mr. Schwartz’s argument. OPIC and Mr. Schwartz would essentially have the rates of Texas homeowners be subsidized by the policyholders of SFL-affiliated companies in other states. There is no basis in the law for such an arrangement. Chapter 2251 of the Code dictates that each “insurer” is entitled to a rate that relates to the risks that the insurer covers under the policies it writes.<sup>76</sup> In this case, the insurer is SFL, not SFL plus all of its affiliates.

For the reasons discussed by SFL above, the ALJs are convinced that SFL faces elevated risks because it issues only homeowners policies in a single state, and that coverage includes

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<sup>70</sup> SFL Ex. 4 (Appel Direct) at 9.

<sup>71</sup> SFL Ex. 4 (Appel Direct) at 9.

<sup>72</sup> SFL Ex. 4 (Appel Direct) at 10.

<sup>73</sup> SFL Ex. 2 (Kelley Direct) at 32.

<sup>74</sup> OPIC Ex. 4 (Schwartz Rebuttal) at 46-47.

<sup>75</sup> SFL Brief at 62-63; Tr. at 524-25.

<sup>76</sup> Code § 2251.052(b).

catastrophe coverage in a catastrophe-prone state. Other than his argument regarding out-of-state State Farm affiliates, Mr. Schwartz did not meaningfully challenge the notion that SFL faces these kinds of elevated risks. Indeed, he agreed that: (1) SFL is a “higher than average risk business . . . compared to the property/casualty insurance industry as a whole;”<sup>77</sup> and (2) the fact that SFL is a single-line insurer in a catastrophe-prone line of insurance in a catastrophe-prone state should have a bearing on the size of the profit that should be earned by the company.<sup>78</sup> Having concluded that SFL must face these elevated risks, the ALJs further conclude that the risks should be taken into account when calculating the company’s underwriting profit.<sup>79</sup>

## 2. SFL Must Pay a Large, Outstanding Surplus Note

In Docket 09-0927, Commissioner Geeslin found that SFL faced elevated risk because it was obligated to repay a \$1.05 billion surplus note along with related interest, thereby justifying a higher underwriting profit for the company.<sup>80</sup> SFL contends these facts remain true today.

In the 2000-2002 period, SFL suffered from a series of significant losses, including 80 catastrophes and a great number of mold claims which resulted in a complete depletion of the company’s surplus. Absent an infusion of additional capital, the company would have faced bankruptcy. In order to avoid this result, SFL purchased a \$1.05 billion surplus note from State Farm Mutual Automobile Insurance Company (SF Auto).<sup>81</sup> The company has been making payments on the surplus note ever since, but it still owes more than \$500 million on it, and the outstanding balance is due by the end of 2016. The form and substance of the surplus note were approved in advance by the Department.<sup>82</sup>

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<sup>77</sup> Tr. at 288.

<sup>78</sup> Tr. at 295.

<sup>79</sup> More will be said on the relation of elevated risks and the underwriting profit provision in Section III.D. of this PFD.

<sup>80</sup> Geeslin Order at Finding of Fact (FOF) 148.

<sup>81</sup> SFL Ex. 4 (Appel Direct) at 8.

<sup>82</sup> Tr. at 273-74.

The Department has previously held that the existence of the surplus note creates an additional element of risk faced by SFL, thereby justifying an increase in the company's underwriting profit provision. Specifically, in Docket 09-0927, Commissioner Geeslin wrote as follows:

[I]t 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 . . . ; (2) an appropriate premium to surplus ratio or cost of capital; and (3) an appropriate underwriting profit provision.<sup>83</sup>

SFL contends that, just as it was relevant when Commissioner Geeslin issued his order in Docket 09-0927, the surplus note remains relevant today. ASOP 30 specifies that an insurer's "debt structure" is one of the risks that its cost of capital should reflect. Thus, the surplus note should affect the company's cost of capital, thereby justifying an elevated underwriting profit.<sup>84</sup>

Like Commissioner Geeslin in Docket 09-0927, the ALJs are convinced that SFL faces an additional element of risk because it must pay the surplus note, and that risk should be taken into account when calculating the company's underwriting profit. Mr. Schwartz did not challenge this point. Indeed, he agreed that the existence of the surplus note should have a bearing on the size of the profit that should be earned by the company.<sup>85</sup>

### **3. SFL Faces Unusual Texas and SFL-Specific Regulatory Risks**

Pursuant to ASOP 30, an insurer's cost of capital should take into account the regulatory risks faced by the company. SFL argues that it is subject to high regulatory risks in Texas. It points to four examples of what it considers adverse, and unjustified, regulatory outcomes it has dealt with in the recent past. First, in 2000-2002, it was forced to pay a great number of mold claims that it argued were not covered by its policies. In 2006, it obtained a Texas Supreme Court decision which

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<sup>83</sup> Geeslin Order at FOF 127.

<sup>84</sup> OPIC Init. Brief at 65.

<sup>85</sup> Tr. at 295.

vindicated the company by holding that the policy form in effect in 2000-2002 did not cover mold claims.<sup>86</sup> Nevertheless, by that time, the company had been forced to pay hundreds of millions of dollars in claims and associated costs that had never been built into its premiums.<sup>87</sup>

Second, in 2003 SFL was ordered by the Commissioner to prospectively reduce its rates by 12%. That order was judicially reversed five years later, on the grounds that the Commissioner applied an unconstitutional standard.<sup>88</sup> The ensuing Commissioner's order in 2009 retroactively set SFL's rates at -6.2% for 2003-04 and -3.4% for 2004-08, thereby requiring SFL to pay refunds of roughly \$257 million, plus interest. SFL contends that the 2009 order was erroneous in this regard and is challenging it on appeal.<sup>89</sup> As a result, it has incurred the expenses and uncertainty of at least "a full decade of litigation over its 2003 rates" and, unless and until its appeal is successful, the company will have to pay out refunds of \$257 million, plus interest.<sup>90</sup>

Third, SFL contends that, in response to the company's lawfully authorized right to judicially appeal the 2003 rate reduction ordered by the Commissioner, the Commissioner twice ordered SFL to be placed under rate supervision. The first such Commissioner order was issued in 2004, but then invalidated by a District Court. The second order was issued in 2006. Eventually, in 2008, the Third Court of Appeals held that both Commissioner rate supervision orders were invalid.<sup>91</sup> In the meantime, however, the orders had effectively prevented SFL from implementing rate increases for five years.<sup>92</sup>

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<sup>86</sup> *Fiess v. State Farm Lloyds*, 202 S.W.3d 744, 745 (Tex. 2006).

<sup>87</sup> SFL Brief at 67-68.

<sup>88</sup> *Geeslin v. State Farm Lloyds*, 255 S.W.2d 786, 791 (Tex. App.—Austin 2008, no pet.); *see also*, SFL Brief at 68.

<sup>89</sup> Tr. at 276-77.

<sup>90</sup> SFL Brief at 68; *see also* Tr. at 278-79.

<sup>91</sup> *State Farm Lloyds v. Geeslin*, 267 S.W.3d 438, 444 (Tex. App.—Austin 2008, no pet.); *Texas Dep't of Ins. v. State Farm Lloyds*, 260 S.W.3d 233 (Tex. App.—Austin 2008, no pet.).

<sup>92</sup> SFL Brief at 69.

Fourth, SFL points out that, pursuant to state law,<sup>93</sup> the Texas Windstorm Insurance Association (TWIA), which provides wind insurance to residents in certain coastal counties in Texas, is empowered to require private insurers such as SFL to pay assessments to it to help pay TWIA's claims. Thus, in addition to its own catastrophe claims, SFL is always subject to having to pay an assessment to help defray a portion of TWIA's catastrophe claims.<sup>94</sup>

The ALJs are convinced by SFL's arguments on this point. Mr. Schwartz did not challenge the argument that SFL faces elevated regulatory risks. Indeed, he agreed that the existence of the refund order should be taken into account when calculating the size of the profit that should be earned by the company.<sup>95</sup> For whatever reasons, the last ten-to-twelve years appear to have involved a great deal of strife and litigation between the Department and SFL. Ultimately, SFL's positions have largely been vindicated, but only after incurring substantial expenses and lost opportunity costs. The ALJs conclude it is reasonable to factor this into account, including the still-in-effect order to refund \$257 million, when calculating the company's underwriting profit.

#### **D. Underwriting Profit**

The Code provides that, in setting its rates, an insurer is entitled to include "a reasonable margin for profit."<sup>96</sup> However, the overall rate set by an insurer will be considered "excessive" and, therefore, unsupported, if it is likely to produce a "long-term profit that is unreasonably high in relation to the insurance coverage provided."<sup>97</sup> In its filing, SFL included a 20% underwriting profit

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<sup>93</sup> Code ch. 2210.

<sup>94</sup> SFL Brief at 61, 69.

<sup>95</sup> Tr. at 295.

<sup>96</sup> Code § 2251.052(a)(7).

<sup>97</sup> Code § 2251.051(b).

provision.<sup>98</sup> In choosing the profit provision, SFL's goal was to achieve a "GAAP Adjusted Return" of 9.6%.<sup>99</sup> The underwriting profit provision is expressed as a percentage of the rate.<sup>100</sup>

### 1. OPIC's Evidence and Arguments

OPIC's witness, Mr. Schwartz, testified that the 20% profit provision used by SFL is excessive. Mr. Schwartz examined the actual profits earned by a number of property and casualty insurers during the 22-year period from 1990 to 2011 and determined that, in "the vast majority of states," the operating profits for those companies on an after-tax basis was less than 7.5%.<sup>101</sup> Therefore, Mr. Schwartz opined that a 7.5% underwriting profit provision (after taxes) for SFL would be reasonable or perhaps "somewhat high." Assuming a corporate income tax rate of 35%, Mr. Schwartz then converted the 7.5% after-tax value to a pre-tax underwriting profit provision of 11.5%. From this value, Mr. Schwartz subtracted 1.7% (because SFL anticipates investment income on its reserves equivalent to 1.7% of premiums) to arrive at 9.8%. According to Mr. Schwartz, by this methodology he concluded that the "indicated underwriting profit provision" for SFL is 9.8%. However, in his analysis, he rounded up and assumed a 10% underwriting profit provision.<sup>102</sup> He asserted that, by using an excessive underwriting profit provision of 20% (rather than a 10% profit provision as he recommends), SFL overstated its indicated rate level by "about 16.0%."<sup>103</sup>

Mr. Schwartz was also critical of the assumptions used by SFL in arriving at its profit provision. In choosing a profit provision of 20%, SFL's goal was to achieve a "GAAP Adjusted Return" of 9.6%. In making its calculations, SFL assumed a surplus-to-premium ratio of 2.0. Mr. Schwartz points out, however, that SFL's actual surplus-to-premium ratio in 2011 was much lower, at roughly 0.53.<sup>104</sup> Thus, OPIC points out, SFL chose to use a hypothetical 2.0 surplus-to-

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<sup>98</sup> SFL Ex. 2 (Kelley Direct) at 26; SFL Ex. 1 (Rate Filing) at 212-14.

<sup>99</sup> Tr. at 505.

<sup>100</sup> ASOP 30, Section 2.15 (found at SFL Ex. 2 (Kelley Direct) at 245).

<sup>101</sup> OPIC Ex. 3 (Schwartz Direct) at 3111.

<sup>102</sup> OPIC Ex. 3 (Schwartz Direct) at 20-21.

<sup>103</sup> OPIC Ex. 3 (Schwartz Direct) at 23.

<sup>104</sup> OPIC Ex. 3 (Schwartz Direct) at 21-22.

premium ratio that is roughly four times the size of its actual surplus-to-premium ratio at the time of its filing.<sup>105</sup> OPIC contends it is more reasonable to rely upon the actual ratio reflected in SFL's financial statements on file with TDI (0.53) than it is to use SFL's hypothetical ratio (or target ratio) of 2.0.<sup>106</sup> Mr. Schwartz conceded that it is not inherently or always wrong to use a target ratio instead of an actual ratio. Rather, he believes it was inappropriate for SFL to use a target ratio under the circumstances of this case.<sup>107</sup> OPIC stresses that SFL has no plans to increase its actual surplus-to-premium ratio to anything close to 2.0. Mr. Kelley admitted that SFL had never had an actual surplus of that size in the past decade and, barring some unusual and foreseen event, will probably not in the future.<sup>108</sup>

OPIC contends that, when SFL made its calculations for determining its GAAP Adjusted Return, it should have used its actual surplus-to-premium ratio of 0.53 rather than a projected or target ratio of 2.0. If it had done so, Mr. Schwartz testified, the 20% underwriting profit provision would have resulted in an "extremely high" GAAP Adjusted Return of 27.8% for SFL. Moreover, Mr. Schwartz's recommended 10% underwriting profit provision coupled with a surplus-to-premium ratio of 0.53 would result in a GAAP Adjusted Return of 16.8% which, according to Mr. Schwartz, "is still very high." According to Mr. Schwartz, if SFL's goal is a GAAP Adjusted Return of 9.6% and a surplus-to-premium ratio of 0.53 is used, then the underwriting profit provision would need to be only 3.4%.<sup>109</sup> OPIC also points out that the profit provision sought by SFL would result in significantly higher returns than achieved by other property and casualty companies over recent years.<sup>110</sup>

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<sup>105</sup> OPIC Init. Brief at 38.

<sup>106</sup> OPIC Init. Brief at 38.

<sup>107</sup> Tr. at 254-55.

<sup>108</sup> Tr. at 388, 390.

<sup>109</sup> OPIC Ex. 3 (Schwartz Direct) at 21-22.

<sup>110</sup> OPIC Init. Brief at 10.

## 2. SFL's Evidence and Arguments

The Code and the Department's rules state that an insurer is entitled to include a "reasonable," but not "excessive" or "unreasonable," margin of profit in its rates.<sup>111</sup> The Code and rules do not provide any elaboration as to what constitutes a reasonable, unreasonable, or excessive margin of profit. However, according to CAS Ratemaking Principle 4, "A rate is reasonable and not excessive . . . if it is an actuarially sound estimate of the expected value of all future costs associated with an individual risk transfer."<sup>112</sup> SFL witness Robert Kelley contends that the phrase "all future costs," as used in CAS Ratemaking Principle 4, includes the "cost of capital" or "opportunity cost" (meaning "the rate of return that capital invested in the insurance enterprise could be expected to earn in alternative investments of equivalent risk").<sup>113</sup>

Additionally, ASOP No. 30 specifies that the cost of capital determination is insurer-specific and must take into account the level of risk the insurer is exposed to based upon the type of insurance it provides.<sup>114</sup> Mr. Kelley testified that the approach taken by SFL in calculating its underwriting profit provision was consistent with ASOP No. 30.<sup>115</sup> Another of SFL's witnesses, Dr. Appel, actually served on the Task Force on Rate of Return of the Casualty Committee of the ASB and helped write ASOP No. 30. He agreed that SFL's approach complied with ASOP No. 30.<sup>116</sup>

Pursuant to ASOP No. 30, insurance rates should provide for all expected costs, including the cost of capital. ASOP No. 30 specifies that there are two acceptable methods for determining the cost of capital. In the first method, the insurer estimates the cost of capital and then translates it into an underwriting profit provision, "after taking leverage and investment income into account." In the

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<sup>111</sup> Code §§ 2251.051(b), and 2251.052(a)(7).

<sup>112</sup> SFL Ex. 2 (Kelley Direct) at 102.

<sup>113</sup> SFL Ex. 2 (Kelley Direct) at 24.

<sup>114</sup> SFL Ex. 2 (Kelley Direct) at 24-25, and at 245 (ASOP No. 30).

<sup>115</sup> SFL Ex. 2 (Kelley Direct) at 25-26.

<sup>116</sup> SFL Brief at 54-55; Tr. at 490.

second method, the insurer develops an underwriting profit provision and tests it for consistency with the cost of capital.<sup>117</sup> In the present case, SFL chose to use the second method.<sup>118</sup>

In order to understand SFL's arguments and positions on this issue, it is necessary to analyze in some detail the history and method by which the company selected a 20% underwriting profit provision. As explained by Commissioner Geeslin in Docket 09-0927, there are two basic approaches by which underwriting profit may be determined:

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. 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.<sup>119</sup>

Commissioner Geeslin went on to explain that, in the second method, the theoretical, risk-adjusted level of capital is commonly derived from adjusting the surplus-to-premium ratio.<sup>120</sup>

In its filing, SFL utilized the second method identified by Commissioner Geeslin. That is, it chose what it considers to be an average rate of return on its capital (a GAAP Adjusted Return of 9.6%) and then increased the projected amount of its capital to account for the risks faced by the company (by assuming a projected surplus-to-premium ratio of 2.0, rather than the company's actual ratio which, although highly variable, has recently averaged around 0.53).

The company selected the target surplus-to-premium ratio of 2.0 to take into account the elevated risks faced by the company. As explained by Mr. Kelley:

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<sup>117</sup> ASOP No. 30, Section 3.1 (found at SFL Ex. 2 (Kelley Direct) at 245).

<sup>118</sup> SFL Brief at 56.

<sup>119</sup> Geeslin Order at 69 (footnote omitted).

<sup>120</sup> Geeslin Order at 69 n. 190.

A fundamental principle of finance is that risk and return are positively correlated—that is, the greater the risk, the greater the return that investors will demand for exposing their capital to that heightened risk. . . . Under ASOP No. 30 and economic theory, SFL is entitled to compensation for the volatility of risk to its capital, and that comes through profit and/or capital levels commensurate with the level of that risk. . . . [In light of the elevated risks faced by it,] SFL has chosen to recognize it in the target surplus-to-premium ratio of 2 to 1.<sup>121</sup>

Dr. Appel agreed that, in insurance ratemaking, higher risks are often taken into account by assuming a higher (or “risk adjusted”) level of capital (or surplus) than the insurer actually has on hand.<sup>122</sup>

Dr. Appel opined that the company’s selection of a ratio of 2.0 was “reasonable,” “appropriate and prudent,” and “somewhat conservative.”<sup>123</sup>

SFL argues that its selection of a surplus-to-premium ratio of 2.0 is also buttressed by the analyses it conducted which concluded that, in the absence of reinsurance, it would need to have on hand \$2 of surplus for every \$1 of premium collected (which would equate to roughly \$3.8 to 4 billion based upon the company’s recent collections in premiums) in order to have a sufficient surplus to pay all claims in the event of a major catastrophe on the order of something that occurs only once in 100 years.<sup>124</sup> Mr. Kelley pointed out that, rather than maintaining such a large surplus, the company retains a smaller surplus and “rents” additional surplus in the form of reinsurance totaling roughly \$4 billion.<sup>125</sup>

According to Mr. Kelley, SFL selected a GAAP Adjusted Return of 9.6% because it believes it to be a rate of return that is on the “low end” of returns for comparable companies.<sup>126</sup> Mr. Kelley reviewed studies indicating that returns for major industries from 1997-2010 were in the range of

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<sup>121</sup> SFL Ex. 2 (Kelley Direct) at 30-31

<sup>122</sup> SFL Ex. 4 (Appel Direct) at 11.

<sup>123</sup> SFL Ex. 4 (Appel Direct) at 12-13.

<sup>124</sup> SFL Ex. 2 (Kelley Direct) at 32-34; Tr. at 347, 392.

<sup>125</sup> Tr. at 392.

<sup>126</sup> SFL Ex. 2 (Kelley Direct) at 31; SFL Ex. 1 (Filing) at 213.

7% to 19%, with an average of around 11%, on a GAAP adjusted basis. Therefore, he concluded that 9.6% was “in line with these other industries’ comparable total returns.”<sup>127</sup>

It is important to note that SFL developed its rates using the “direct” method, as opposed to the “net ratemaking” method. In direct ratemaking, reinsurance costs are not treated as a separate, stand-alone expense item in the rates.<sup>128</sup> However, according to SFL witness Appel, because reinsurance costs represent a cost of capital to the insurer, those reinsurance costs are appropriately taken into account when calculating the insurer’s underwriting profit factor.<sup>129</sup> As explained by Mr. Kelley, the direct approach considers premiums, losses, and expenses without any explicit allowance for reinsurance, “although reinsurance is a consideration in determining the appropriate total return and leverage as noted in ASOP 30.”<sup>130</sup> According to Mr. Kelley, SFL has used the direct ratemaking approach in previous ratemaking efforts, without objection from the Commissioner.<sup>131</sup>

SFL also disputes the positions taken by OPIC on the issue of underwriting profit. First, SFL challenges Mr. Schwartz’s preference for an *actual* surplus-to-premium ratio as opposed to a *target* surplus-to-premium ratio.<sup>132</sup> According to Mr. Kelley, it is “inappropriate and financially unsound” to rely upon an actual ratio rather than a target ratio. He explained, “An underwriting profit provision should be calculated based on a target surplus-to-premium ratio that will allow an insurer to put itself on sounder financial footing without charging excessive premiums.”<sup>133</sup>

SFL explains that a “surplus” is the capital that an insurer has on hand over and above the amount of the premiums and other interest earned by the insurer for any given period. The surplus would be needed in the event the total claims submitted to the insurer exceeded the premiums and

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<sup>127</sup> SFL Ex. 2 (Kelley Direct) at 35.

<sup>128</sup> Tr. at 495. By contrast, in net ratemaking, reinsurance costs *are* treated as a stand-alone expense item in the rates.

<sup>129</sup> Tr. at 495-96.

<sup>130</sup> SFL Ex. 2 (Kelley Direct) at 27.

<sup>131</sup> SFL Ex. 2 (Kelley Direct) at 27.

<sup>132</sup> OPIC describes the 2.0 surplus-to-premium ratio as a “hypothetical” ratio, while SFL refers to it as a “target” ratio.

<sup>133</sup> SFL Ex. 2 (Kelley Direct) at 36.

other interest collected by the insurer.<sup>134</sup> SFL contends that the target surplus-to-premium ratio of 2.0 was selected in order to take into account the unique risks faced by the company. In this context, SFL defines a “target surplus” to mean “the amount of capital that is needed to be certain that [SFL] can pay policyholder claims, even in years of extreme losses, whether due to catastrophe events or to unexpected debacles, like the mold crisis.”<sup>135</sup> SFL does not intend for the phrase “target surplus” to mean that the company is planning to actually build up its surplus to that level.

SFL also challenges Mr. Schwartz’s analysis of the historical profit margins of other property and casualty insurers. Mr. Schwartz opined that a 7.5% underwriting profit for SFL would be appropriate. He based this conclusion on his analysis of actual profits earned by insurers nationwide from 1990 to 2011. Based upon that study, Mr. Schwartz concluded that, in “the vast majority of states, the insurance operating profit on an after-tax basis was less than 7.5% of premium.”<sup>136</sup> Mr. Schwartz acknowledged, however, that the data he relied upon shows that from 1990 to 2011 homeowners insurers in Texas averaged a profit of negative 3.7%.<sup>137</sup> Moreover, Mr. Schwartz’s data further indicates that, of the 50 states, homeowners insurers in 29 states averaged negative operating profits for the period from 1990 to 2011.<sup>138</sup>

Instead of examining the historical returns of only homeowners insurers in order to determine what the appropriate rate of return would be for SFL, Mr. Schwartz looked at the nationwide, historical returns for all kinds of insurance companies over the 1990-2011 time period. Based on that much wider set of criteria, from 1990 to 2011 all insurers in Texas averaged a profit of only 0.6%, and all insurers nationwide averaged a profit of only 3.7%.<sup>139</sup> Using this data, Mr. Schwartz admitted that he made a “judgment call” that 7.5% would be a reasonable profit for SFL.<sup>140</sup>

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<sup>134</sup> SFL Brief at 56-57.

<sup>135</sup> SFL Brief at 57.

<sup>136</sup> OPIC Ex. 3 (Schwartz Direct) at 21, 3111-12.

<sup>137</sup> Tr. at 283-84; *see also* OPIC Ex. 3 (Schwartz Direct) at 3111-12.

<sup>138</sup> OPIC Ex. 3 (Schwartz Direct) at 3111.

<sup>139</sup> Tr. at 285-87; *see also* OPIC Ex. 3 (Schwartz Direct) at 3112.

<sup>140</sup> Tr. at 293.

Mr. Kelley testified that the nationwide and all-lines of insurance data relied upon by Mr. Schwartz to arrive at his recommended 7.5% profit were wholly inappropriate and ignore the risks faced by SFL. Mr. Kelley believes that the appropriate profit for SFL can only be arrived at by analyzing the data specific to SFL.<sup>141</sup> Likewise, Dr. Appel offered the opinion that the method by which Mr. Schwartz selected a 7.5% profit lacked any actuarial basis or foundation. He described Mr. Schwartz's reliance upon historical data from all kinds of insurers from all fifty states as a "terrible proxy" for attempting to measure SFL's risks going forward.<sup>142</sup> Likewise, Mr. Schwartz's data showed that homeowners insurers in Texas, on average, lost money from 1990 to 2011, indicating that historic rates have been too low and, therefore, not fair and reasonable. Dr. Appel also argued that these too-low rates have resulted in capital abandoning the homeowners insurance market in Texas.<sup>143</sup> Dr. Appel also described Mr. Schwartz's method as being "completely arbitrary," lacking any standards, not replicable by other actuaries, and "completely improper."<sup>144</sup>

In arriving at his preferred rate of return of 7.5%, Mr. Schwartz did not claim, in his pre-filed testimony, to have considered SFL-specific risks. Dr. Appel explained that if, as was done by Mr. Schwartz, one relies upon historical returns as a basis for estimating a required return in the future, then one must assume that those historical returns were reasonable and consistent with the risk of the investment at the time, and that future conditions will be the same as the historical conditions. In the present case, however, Dr. Appel believes neither assumption is accurate. That is, he contends that the historical returns upon which Mr. Schwartz relied (average annual profits over a 22-year period of: negative 3.7% for homeowners insurers in Texas; 0.6% for all insurers in Texas; negative 2.7% for homeowners insurers nationwide; and 3.7% for all insurers nationwide) have not been reasonable, and the conditions affecting risk have changed significantly.<sup>145</sup>

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<sup>141</sup> Tr. at 356-57.

<sup>142</sup> Tr. at 507-13.

<sup>143</sup> Tr. at 510-11.

<sup>144</sup> Tr. at 514; SFL Ex. 4 (Appel Direct) at 27-28.

<sup>145</sup> SFL Ex. 4 (Appel Direct) at 29-30.

SFL also contends that it is required to take into account its reinsurance costs when calculating its rate. Mr. Kelley pointed out that, pursuant to CAS Ratemaking Principle Nos. 1 and 2, “A rate is an estimate of the value of future costs;” the rate “provides for all costs associated with the transfer of risk;” and within the ratemaking process, “[c]onsideration should be given to the effect of reinsurance agreements.”<sup>146</sup> Likewise, Mr. Kelley points out that ASOP No. 30 lists reinsurance as a consideration for an insurer’s cost of capital estimates:

3.2 Basis for Cost of Capital Estimates—In estimating the cost of capital, the actuary should consider the relationship between risk and return. The methods used for estimating the cost of capital should reflect the risks involved in the risk transfer under consideration. These risks may include insurance, investment, . . . *reinsurance*, market structure, and other appropriate aspects of the social, economic, and legal environments.<sup>147</sup>

Similarly, ASOP No. 29 clarifies that reinsurance may be considered as an expense for ratemaking purposes.<sup>148</sup>

According to Mr. Kelley, when SFL prepared its filing, it could have taken its reinsurance costs into account in one of two ways (either of which method is commonly used by insurers): (1) as an additional expense component; or (2) as one of the considerations in the development of the underwriting profit provision. SFL chose to take the second approach.<sup>149</sup> The company calculated its net cost of reinsurance (10%) and used that cost “as a point of reference” in determining its underwriting profit provision. The 10% cost figure is not, however, “directly inserted into any indicated rate change calculation.”<sup>150</sup>

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<sup>146</sup> SFL Ex. 2 (Kelley Direct) at 14.

<sup>147</sup> SFL Ex. 2 (Kelley Direct) at 14, 245 (emphasis added).

<sup>148</sup> SFL Ex. 2 (Kelley Direct) at 15

<sup>149</sup> SFL Ex. 2 (Kelley Direct) at 15.

<sup>150</sup> SFL Ex. 2 (Kelley Direct) at 15-16.

### 3. ALJs' Analysis

The ALJs conclude OPIC failed to prove that the 20% underwriting profit provision selected by SFL is unreasonable or excessive. There is clear precedent for the approach taken by SFL. In Docket 09-0927, Commissioner Geeslin explained that, in developing an underwriting profit, an insurer may use “an average rate of return” and a “theoretical, risk-adjusted, level of capital.” He further specified that the risk-adjusted level of capital may be derived by adjusting the surplus-to-premium ratio. SFL did just this by selecting a GAAP Adjusted Return of 9.6% and then adjusting the surplus-to-premium ratio upward to 2.0. Those two factors in combination lead to a 20% underwriting profit provision.<sup>151</sup>

SFL presented convincing evidence demonstrating that its choice of a target GAAP Adjusted Return of 9.6% was reasonable and in line with (or perhaps even on the low side of) returns earned by comparable companies. OPIC did not meaningfully challenge the merits of SFL's selection of 9.6%. Rather, Mr. Schwartz relied upon his own data to select what the ALJs consider to be an arbitrary and indefensible underwriting profit of 7.5% (10% before taxes). Mr. Schwartz's analysis of data showing the historical profits for insurers of all lines in all states was inappropriate and meaningless for analyzing SFL's costs at issue in this case. To the extent they illustrate anything of value, it is that the profits historically earned by homeowners insurers, especially those in Texas and other catastrophe-prone states, have been unreasonably and unfairly low. Relying on this data, Mr. Schwartz made a judgment call that an underwriting profit of 7.5% would be reasonable. The ALJs conclude that Mr. Schwartz's analysis was not made in accordance with accepted actuarial standards. Thus, the ALJs conclude that the target of a GAAP Adjusted Return of 9.6% chosen by SFL is reasonable and would not lead to excessive profits.

The ALJs are likewise convinced that SFL's decision to use a target surplus-to-premium ratio of 2.0 was reasonable and does not lead to excessive profits. As discussed in Section III.C. of this PFD, the ALJs have already concluded that SFL is subject to an unusually high level of risks due to a

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<sup>151</sup> Tr. at 505.

number of factors and, as a result of this elevated level of risk, the company is entitled to an increased underwriting profit.

- Like Commissioner Geeslin in Docket 09-0927, the ALJs have concluded that SFL faces elevated the risks because it issues, almost exclusively, homeowners policies in a single state, including catastrophe coverage in a catastrophe-prone state, thereby justifying a higher underwriting profit for the company.
- Like Commissioner Geeslin in Docket 09-0927, the ALJs have concluded that SFL faces an additional element of risk because it must pay its surplus note, and that risk should be taken into account when calculating the company's underwriting profit.
- The ALJs have concluded that SFL is subject to unusually high regulatory risks in Texas, including a still-in-effect order to refund \$257 million, which should be taken into account when calculating the company's underwriting profit.

All of these elevated risks must be accounted for in SFL's rates, and the company acted appropriately in accounting for them via the underwriting profit. Mr. Kelley and Dr. Appel both provided expert opinion that a surplus-to-premium ratio of 2.0 was reasonable and prudent in light of the risks faced by the company.

The target surplus-to-premium ratio is also appropriate because it includes, indirectly but necessarily, consideration of the company's reinsurance costs. In order to understand this point, it is helpful to examine the treatment of reinsurance in Docket 09-0927. In that docket, SFL used the "net ratemaking" approach, rather than the "direct" approach used in the present case. In net ratemaking, reinsurance expenses are treated as a stand-alone expense item in the rates. Thus, in Docket 09-0927, Commissioner Geeslin approved a rate that included a separate expense provision for the net cost of reinsurance purchased by SFL, in the amount of 3.1%.<sup>152</sup> Turning to the underwriting profit provision, Commissioner Geeslin found Dr. Appel's testimony on the topic of the use of a target surplus-to-premium ratio to be "convincing," but stated that 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."<sup>153</sup> (Commissioner Geeslin's discussion is couched in terms of the

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<sup>152</sup> Geeslin Order at 46-47; Tr. at 305-06.

<sup>153</sup> Geeslin Order at 72.

“premium-to-surplus” ratio, rather than a “surplus-to-premium” ratio. However, a premium-to-surplus ratio of 0.5 equals a surplus-to-premium ratio of 2.0.) In other words, Commissioner Geeslin concluded that a surplus-to-premium ratio of 2.0 was not supportable in Docket 09-0927 *because SFL’s reinsurance costs were already accounted for elsewhere in the company’s rate.* Commissioner Geeslin ultimately concluded that a reasonable surplus-to-premium ratio in that case was somewhere between 1.0 and 2.0.<sup>154</sup> This indicates that in cases such as the present case, where SFL’s reinsurance costs are not accounted for elsewhere in its rates, a surplus-to-premium ratio of 2.0 would be reasonable.

As discussed in Section III.B. of this PFD, SFL estimates its annual reinsurance costs will be \$347 million, which equates to 10% of premium. The ALJs have found these amounts to be reasonable. The evidence presented by SFL demonstrates: (1) in the absence of reinsurance, the company would need to maintain a surplus of roughly \$4 billion in order to have sufficient funds in the event of a major catastrophe on the order of something that occurs only once in a 100 years; (2) a surplus of that size would equate to a surplus-to-premium ratio of 2.0; and (3) the company has opted to ensure it has the necessary \$4 billion available to it by amassing a cash surplus of a portion of the \$4 billion and purchasing reinsurance for the remainder. In other words, through its purchase of reinsurance, SFL is “renting” surplus necessary to meet its needs. There is nothing inherently wrong with such an approach, and the company is entitled to a rate that takes these reinsurance costs into account. The costs were appropriately taken into account by assuming a target surplus-to-premium ratio rather than by using SFL’s actual ratio. As explained by Dr. Appel, this is “precisely why it is appropriate for SFL to utilize a premium to surplus ratio of 0.5 [or, conversely, a surplus-to-premium ratio of 2.0] in developing indicated rates.”<sup>155</sup>

Even Mr. Schwartz conceded that SFL implicitly took its reinsurance costs into account when it calculated its underwriting profit provision.<sup>156</sup> Mr. Schwartz also conceded that to ensure it can pay all of its policyholders’ claims in an above-average catastrophe year, an insurer can either buy

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<sup>154</sup> Geeslin Order at 72-73.

<sup>155</sup> SFL Ex. 4 (Appel Direct) at 19.

<sup>156</sup> OPIC Ex. 3 (Schwartz Direct) at 25.

reinsurance or accumulate and maintain a cash surplus that is large in relation to the company's annual premiums.<sup>157</sup> It is precisely for this reason that the ALJs reject Mr. Schwartz's proposed approach to the underwriting profit provision.

Under SFL's approach, by using a target ratio of 2.0, the company would earn a 20% underwriting profit, but the underwriting profit would include consideration of company's reinsurance costs, which are roughly 10% of premium. By this method, the company would be left with a GAAP Adjusted Return of 9.6%. (This is effectively no different than if, rather than using the direct ratemaking approach, the company had used the net ratemaking approach, whereby the company could have included a 10% underwriting profit and an 10% reinsurance expense item in the rates.)

Mr. Schwartz's approach, by contrast, would create a windfall for ratepayers by denying SFL the right to have its reinsurance expenses accounted for in its rates. He advocates using SFL's actual surplus-to-premium ratio of 0.53, which leads to an underwriting profit of 10% (7.5% after taxes). However, after considering SFL's reinsurance expenses at 10% of premiums, SFL's profit would be reduced to roughly 0%, an unreasonable outcome. OPIC argues that SFL's cost of reinsurance should in no way be considered when calculating the company's rate.<sup>158</sup> The ALJs disagree. ASOP No. 30 explicitly states that the cost of "reinsurance" should be taken into account as a risk faced by an insurer when estimating the company's cost of capital. Moreover, ASOP No. 29 states that reinsurance is a legitimate expense for ratemaking purposes.

For all of the foregoing reasons, the ALJs conclude that OPIC failed to meet its burden to prove that the 20% underwriting profit provision included in SFL's rates is excessive.

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<sup>157</sup> Tr. at 141.

<sup>158</sup> OPIC Reply Brief at 7.

## E. Contingency

SFL calculated a 2% contingency provision in its indicated rate increase. OPIC considered that contingency provision to be unsupported and unjustified. Elimination of the contingency provision would reduce SFL's indicated rate by approximately \$36.

The ALJs find that the contingency provision was not adequately supported by the evidence and should be excluded from SFL's indicated rate.

### 1. Parties' Evidence and Arguments

The Casualty Actuarial Society (CAS) Ratemaking Principles state that a company's rate "should also include a charge for any systematic variation of the estimated costs from the expected costs. This charge should be reflected in the determination of the contingency provision."<sup>159</sup>

ASOP No. 30 defines the contingency provision as:

A provision for the expected differences, if any, between the estimated cost and the average actual costs that cannot be eliminated by changes in other components of the ratemaking process.<sup>160</sup>

SFL's rate filing set out the contingency provision of 2% and a summary of its contingency study.<sup>161</sup> In his direct testimony, Mr. Schwartz characterized SFL's contingency provision as "unsupported" and testified that it should be eliminated. Mr. Schwartz quoted ASOP No. 30 guidelines on when a contingency provision should be included:

The actuary should include a contingency provision if the assumptions used in the ratemaking process produce cost estimates that are not expected to equal average actual cost, and if this difference cannot be eliminated by changes in other components of the ratemaking process. While the estimated costs are intended to equal the average actual cost over time, differences between the estimated and actual

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<sup>159</sup> OPIC Ex. 3 (Schwartz Direct) at 23; SFL Ex. 2 (Kelley Direct) at 104.

<sup>160</sup> SFL Ex. 2 (Kelley Direct) at 42.

<sup>161</sup> OPIC Ex. 247, 255; SFL Ex. 1 at 212, 221.

costs of the risk transfer are to be expected in any given year. If a difference persists, the difference should be reflected in the ratemaking calculations as a contingency provision. The contingency provision is not intended to measure the variability of results and, as such, is not expected to be earned as profit.<sup>162</sup>

As summarized by Mr. Schwartz, a contingency provision may be appropriate if there is a systematic bias in the ratemaking process that cannot otherwise be fixed. Mr. Schwartz testified that SFL's filing did not show that the assumptions used in the ratemaking process produced costs estimates that were not expected to equal average actual costs. In his opinion, the filing also did not show that any such disparity, if it existed, could not be eliminated by other components of the ratemaking process.

SFL witness Robert Kelley responded to Mr. Schwartz in his testimony. Mr. Kelley testified that insurers' actual losses and expenses vary around the expected cost from year to year. If the variation is random and not biased, over a period of time the actual results should average to the expected results. However, if there is some basis or systematic variations in the ratesetting process, the average actual results will not equal the average expected results—thus the rationale for a contingency provision.

Mr. Kelley explained that, by systematic variation, he meant the possibility that over the long term SFL's loss estimates will prove inadequate because of various factors that SFL cannot anticipate. Examples of such factors, in general, would include adverse court decisions or legislative changes. In Texas, past unexpected factors have included mold claims and foundation slab losses. Mr. Kelley also identified regulatory actions as possible contributors to shortfalls. He stated that in some states, including Texas, the regulatory environment causes delays to the ability of insurers to implement indicated rate adjustments.<sup>163</sup>

Mr. Kelley stated that State Farm regularly carries out contingency studies based on its public rate filings. Each study includes 10-12 years of information from 46 jurisdictions in which State

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<sup>162</sup> ASOP 30, quoted in OPIC Ex. 3 (Schwartz Direct) at 24.

<sup>163</sup> SFL Ex. 2 (Kelley Direct) at 43-44.

Farm provides homeowners coverage. Texas and several other jurisdictions were not included. Mr. Kelley explained that Texas was not included because there was a five-year period in which no rate filings occurred. Mr. Kelley stated that the study supported a contingency provision of 4.5%. He stated that State Farm has conducted such studies since 2002 and each produced indicated homeowners contingency provisions above the 2% presented in this filing.<sup>164</sup>

According to Mr. Kelley, the lack of rate filings for five years in Texas made the Texas data not credible. He testified that if the existing Texas data were included in the study, it would not appreciably change the result.<sup>165</sup>

Mr. Kelley observed that SFL has included contingency provisions in past filings. The 2011 rates were reviewed by TDI and went into effect as filed. After the hearing on SFL's 2007 rate filing, the ALJs approved the inclusion of a contingency provision. No final Commissioner's order was issued in that case. In the 2009 Order, Commissioner Geeslin did not approve the contingency provision, but acknowledged that a systematic variation might exist.<sup>166</sup>

Mr. Kelley testified that the shortfall identified in the contingency study could not be corrected by better projections, because the contingency provision is intended to address future unanticipated surprises, as opposed to past surprises. Mr. Kelley testified that State Farm's ratemaking methodologies have not changed significantly over the years. He stated that changes in SFL's homeowners policy contract or forms could prevent specific, past shortfalls from recurring, but could not anticipate new issues that past events could not predict.

Mr. Kelley denied that trending of past losses into the future could address the variations shown in the contingency study. He observed that, if trending eliminated shortfalls in expected losses versus actual losses, the data would not show a pattern of shortfalls. He also denied that

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<sup>164</sup> SFL Ex. 2 (Kelley Direct) at 45; Tr. at 367-68. The relevant study was included as an exhibit to Mr. Kelley's testimony. SFL Ex. 2 at 421 (Kelley Ex. 26).

<sup>165</sup> SFL Ex. 2 (Kelley Direct) at 46.

<sup>166</sup> SFL Ex. 2 (Kelley Direct) at 48; Tr. at 181-82 (Schwartz cross-examination).

competitive pressures had influenced State Farm to file or implement less of an adjustment than it believed was needed. The study, said Mr. Kelley, quantified the difference between what was filed for a rate indication and what was actually implemented.<sup>167</sup>

Mr. Kelley, not surprisingly, did not know what unanticipated events might occur, but stated that increasing lawsuits related to the 2012 hail storms were one possibility. He declared that there has been a long pattern in Texas of unforeseen events causing unforeseen losses.<sup>168</sup>

In rebuttal, Mr. Schwartz pointed out that Commissioner Geeslin, in the 2009 Order, rejected a contingency provision. Mr. Schwartz also argued that various items such as adverse court decisions or legislative changes are reflected in the trend projections, so a separate contingency provision is not needed. He provided a table that illustrated the hypothetical growth in unusual adverse experiences and a resulting increase in projected values. Mr. Schwartz pointed out that items such as the Texas mold and foundation slab issues were addressed by changes in the Texas homeowners policy forms.<sup>169</sup>

Mr. Schwartz questioned Mr. Kelley's assertion that State Farm's ratemaking methodologies have not changed significantly during the twelve years encompassed by the contingency study. He pointed to updated hurricane model information and changes in risk classification, identified by Mr. Kelley, that could make Mr. Kelley's assertion "seem suspect."<sup>170</sup>

Mr. Schwartz took issue with Mr. Kelley's assertion that the Texas information by itself is not significantly credible over the 10-12 year time period used for the contingency study. He pointed out that SFL had direct written premiums of at least \$900 million every year from 1998 to 2012. SFL data showed that, during the period from 2003 to 2012, which covers the time period after the mold claims, SFL had an underwriting profit in six years and an underwriting loss in four years for

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<sup>167</sup> SFL Ex. 2 (Kelley Direct) at 50.

<sup>168</sup> SFL Ex. 2 (Kelley Direct) at 51.

<sup>169</sup> OPIC Ex. 4 (Schwartz Rebuttal) at 49-51.

<sup>170</sup> OPIC Ex. 4 (Schwartz Rebuttal) at 52-53.

homeowner's insurance. The unweighted average profit was about 4%. Using figures from other portions of SFL's rate filing and testimony, Mr. Schwartz calculated an average annual profit for SFL from 2003 to 2012 of about 8.4% of premium. Mr. Schwartz stated that those figures show SFL's Texas Homeowners insurance experience does not display a systematic, persistent bias and therefore does not support a contingency provision.<sup>171</sup> Mr. Schwartz testified that, on a direct basis (before reinsurance), SFL had an underwriting profit for homeowners insurance of about \$253.4 million, or about 15% of premium. He also testified that SFL's actual hailstorm losses from 2012 were less than projected.<sup>172</sup>

In his live testimony, Mr. Kelley addressed some of the points made by Mr. Schwartz on rebuttal. He stated that trending had not projected unforeseen losses as suggested by Mr. Schwartz; if it had, the shortfalls would not have appeared in the contingency study. He denied that changes in hurricane modeling or risk classifications would affect the need for the contingency. He also observed that SFL's 2012 profit data, if considered at all, should be considered on an annual catastrophe-year-basis. With such an adjustment, the profit would have been 0.6% of premium.<sup>173</sup>

## 2. ALJs' Analysis

Both witnesses testified that a contingency provision is warranted if there is some bias or systematic variation in the ratemaking process. Mr. Kelley provided examples of factors that may cause such systematic variation. Several of those, such as adverse court decisions, legislative changes, and regulatory actions, are often peculiar to the particular jurisdiction in which the insurer provides coverage—in this case, Texas. Mr. Kelley testified that in Texas, the regulatory environment causes delays in the ability of insurers to implement indicated rate adjustments.<sup>174</sup> That

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<sup>171</sup> OPIC Ex. 4 (Schwartz Rebuttal) at 53-54. *See also* SFL Ex. 2 (Kelley Direct) at 31 (Kelley Ex. 23).

<sup>172</sup> OPIC Ex. 4 (Schwartz Rebuttal) at 55-57. Mr. Schwartz stated that the SFL 2012 Insurance Expense Exhibit (IEE), on which his statement was based, should have become available to SFL by April 1, 2013.

<sup>173</sup> Tr. at 371-74.

<sup>174</sup> SFL Ex. 2 (Kelley Direct) at 43-44.

delay did not seem to have occurred in this case, however, when the rate was filed on September 7, 2012, and took effect on November 1, 2012.

Because the factors that may cause variations between expected and actual costs can be so jurisdiction-specific, the ALJs consider State Farm's contingency study, which summarized State Farm's experience in 46 jurisdictions other than Texas, to be of limited value in determining whether there is likely to be a systematic underrecovery for SFL. The profit/loss data for Texas from 1989-2011 provided by SFL do not show a systematic pattern of underrecovery, excluding the effects of the mold issue.<sup>175</sup>

The ALJs do not agree with all of OPIC's arguments on the contingency issue. For example, they agree with SFL that, if trending eliminated the effects of future unforeseen events, State Farm's contingency study would not show shortfalls in the jurisdictions covered by that study. The ALJs find, however, that the evidence does not justify the inclusion of a contingency provision for Texas in SFL's indicated rates. Exclusion of that provision would reduce SFL's rate indication by \$36.

#### **F. Non-Catastrophe Losses and LAE**

Non-catastrophe losses include all losses other than catastrophe losses—"typical" losses such as thefts, accidents on a homeowner's property, and house fires. SFL projected its non-catastrophe losses based on its historical data through December 31, 2011. SFL's projected non-catastrophe loss per policy, as set out in the rate filing of September 7, 2012, is approximately \$352.

OPIC contended that SFL, at the time of the rate filing, had data available through June 2012, which should have been used. OPIC argued that the more recent data showed a decreasing trend in non-catastrophe losses per policy. OPIC's approach yielded a projected loss per policy of \$326, a

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<sup>175</sup> The ALJs have not considered the 2012 SFL data, partly because of the concerns raised by Mr. Kelley and partly because it was not available at the time of the rate filing. The latter issue is discussed in more detail in Section III. F. of this PFD.

decrease of \$26 from the rates currently in effect. The difference between the two parties' non-catastrophe LAE was \$7, for a total difference of \$33.<sup>176</sup>

The ALJs find SFL reasonably used data through December 31, 2011, in its rate filing. Therefore, they make no adjustment to SFL's projected non-catastrophe losses.

### 1. Parties' Evidence and Arguments

SFL's calculation of projected non-catastrophe losses is set out in the rate filing package and described in Ms. Frankowiak's testimony.<sup>177</sup> SFL began by analyzing historical paid loss frequency, severity, and pure premium for each of the following loss perils:<sup>178</sup> fire other than lightning, fire due to lightning, wind/hail, other extended coverages (which includes specified covered losses due to water and freezing), crime, and liability. It reviewed those coverages by quarter on a rolling 12-month basis, using data through December 31, 2011, and derived the projected loss per policy of \$352.

OPIC's witness, Mr. Schwartz, testified that SFL, when it made its rate filing on September 7, 2012, had data available through at least June 30, 2012, and should have used that data.<sup>179</sup> In his direct testimony, Mr. Schwartz used Texas Homeowners Fast Track experience<sup>180</sup> to project the SFL trend experience through to June 30, 2012. He examined the historical relationship between SFL experience and Fast Track data and found that that the pure premiums trends were reasonably related. He then calculated loss trends using 8-point, 12-point, and 16-point trends

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<sup>176</sup> SFL Brief at 33; SFL treated non-catastrophe LAE as a separate but related item in the chart included in Mr. Kelley's testimony. SFL Ex. 2 at 336 (Kelley Direct).

<sup>177</sup> OPIC Ex. 2 at 235-36 and 256-67; SFL Ex. 1 at 201-02 and 222-33; SFL Ex. 3 (Frankowiak Direct) at 28-30.

<sup>178</sup> Frequency is the number of claims per 100 policies. Severity is the cost per claim. Pure premium is the product of frequency and severity, resulting in the cost per policy. The projected pure premium is the projected average cost per policy. SFL Ex. 3 (Frankowiak Direct) at 29.

<sup>179</sup> Mr. Schwartz thought SFL possibly could have had data available through September 2012, when it made the filing. OPIC Ex. 3 (Schwartz Direct) at 11, fn. 13.

<sup>180</sup> Fast Track data is a sample of insurance industry experience that is compiled and distributed by Insurance Services Office (ISO) and is designed to provide "an early picture of key results by line of insurance based on a sample of insurers . . ." ISO Circular AS-HO-2013-001, quoted in OPIC Ex. 3 (Schwartz Direct) at 13.

through June 1, 2012. The 8-point and 12-point trends showed downward annual loss trends of -1.1% and -1.5%, respectively. The 16-point trend analysis showed an upward annual trend of 2.4%. Based on those results, Mr. Schwartz believed a moderate downward trend of -1.0% would be justified. He selected a more conservative 0% trend, however.

Ms. Frankowiak did not agree with Mr. Schwartz's approach. She stated that the analysis and preparation for a rate filing takes many months and that the projection of the non-catastrophe loss component is one of the first steps of the rate analysis process. According to Ms. Frankowiak, the data from December of 2011 did not become available for analysis until a few months into 2012. It would not have been possible to wait for March 31, 2012, data (which became available on a detailed basis in May of 2012) or June 30, 2012, data (not available until August of 2012) to complete the analysis and documentation necessary for a September 2012 rate filing. Ms. Frankowiak believed that the data SFL used were sufficiently comprehensive, accurate, and timely under ASOP 23, which is concerned with data quality.<sup>181</sup>

Ms. Frankowiak testified that the Fast Track data on which Mr. Schwartz relied were not available until about four months after the close of the quarter—an inadequate amount of time for preparing the rate filing. She also pointed out that the Fast Track data are not SFL-specific.

Ms. Frankowiak testified that, although SFL did not use actual 2012 data, it made adjustments to its 2011 data to account for 2012 expectations. Specifically, SFL recognized that the wildfires that occurred in the second quarter of 2011 were unusual events that had influenced the historical data. SFL selected a frequency ratio of .26, although the three prior quarterly values for 2011 were .31, .30 and .28. For severity, Ms. Frankowiak stated, SFL selected a trend line lower than any of its lines suggested.

In regard to Mr. Schwartz's use of the 16-point, 12-point, and 8-point trends in selecting his trend line, Ms. Frankowiak, noted that in the past Mr. Schwartz has projected SFL's non-

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<sup>181</sup> SFL Ex. 3 (Frankowiak Direct) at 31.

catastrophe losses using six fitted trend lines, including 20 points, 24 points, and 28 points. She calculated those additional trend lines and observed that four of the six trend lines were positive.<sup>182</sup>

Finally, Ms. Frankowiak pointed out that SFL's analysis of frequency and severity was completed separately for each of the separate loss perils. Mr. Schwartz analyzed only pure premium, however. Ms. Frankowiak stated that frequency and severity trend very differently from each other and differently by peril. SFL's approach, in her opinion, was more detailed, thorough, and accurate.<sup>183</sup>

In her live testimony, Ms. Frankowiak reemphasized the amount of time needed to prepare a rate filing and reiterated that one of the first steps is analysis of the non-catastrophe data. She stated that quarterly data, or any data, typically are not available to her until about a month and a half after the data period has ended. She also pointed out that the non-catastrophe data are not considered in isolation from the other data included in the rate filing.<sup>184</sup>

On cross-examination, OPIC presented an email to the Louisiana Department of Insurance (LDI) from Meg Astudillo, who was then a pricing manager for SFL. In that email, dated April 22, 2010, Ms. Astudillo apparently was responding to a request from the LDI for additional information about March 2010 non-catastrophe data. She supplied end-of-March 2010 frequency, severity, and pure premium figures and discussed frequency by peril.<sup>185</sup> In its brief, OPIC argued that the Astudillo email showed that SFL had, or could have had, actual loss experience for 2011 within weeks of the end of the data period, and should have adjusted its non-catastrophe loss projections accordingly. OPIC contended that SFL withheld the relevant data from both the Commissioner and OPIC, until OPIC requested it in discovery, because it was detrimental to SFL's proposed rate filing.

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<sup>182</sup> SFL Ex. 3 (Frankowiak Direct) at 34-35.

<sup>183</sup> SFL Ex. 3 (Frankowiak Direct) at 35-38.

<sup>184</sup> Tr. at 420-27.

<sup>185</sup> OPIC Ex. 7.

In his rebuttal testimony, Mr. Schwartz used actual SFL 2012 data supplied in discovery to illustrate that he had been correct in his prediction that non-catastrophe losses would decrease in 2012. He provided a graph showing SFL pure premium through December 2012 that illustrated his point.<sup>186</sup> That graph shows SFL's unadjusted non-catastrophe pure premium remaining basically unchanged in March 2012 from the previous quarter, then dropping fairly precipitously in each of the subsequent three quarters of 2012.<sup>187</sup> Mr. Schwartz observed that his earlier projection of the non-catastrophe pure premium had been too high based on the actual data.

Mr. Schwartz did not believe his use of data through December of 2012 constituted retrospective ratemaking, despite the fact that the rate filing occurred in early September of 2012. He cited the Geeslin Order, in which the Commissioner based his decision, with some exceptions, on data that was either known or knowable in September 2003, which was the date of the evidentiary hearing in that case.<sup>188</sup> Mr. Schwartz pointed out that the hearing in this case concluded on April 26, 2013, well after December 2012. Even if one ignored the September and December 2012 data, Mr. Schwartz testified, the data through June of 2012 confirmed that his projected non-catastrophe loss pure premium was correct and SFL's was too high.<sup>189</sup>

In response to Ms. Frankowiak's comments about the use of Fast Track data, Mr. Schwartz explained that he had used that data in his direct testimony because he did not have access at that time to SFL data for 2012. He now had that data, which confirmed his earlier testimony. He testified that Fast Track data nevertheless is a common source of trend information and that its use for that purpose is consistent with actuarial standards.

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<sup>186</sup> OPIC Ex. 4 (Schwartz Rebuttal) at 6. The data provided by SFL were unadjusted rather than adjusted data.

<sup>187</sup> See also Tr. at 433-34.

<sup>188</sup> Geeslin Order at 6-7, quoted in OPIC Ex. 4 (Schwartz Rebuttal) at 7.

<sup>189</sup> OPIC Ex. 4 (Schwartz Rebuttal) at 5-8.

Mr. Schwartz was skeptical that SFL had really considered the possibility that the loss experience for the peril of fire other than lightning would decrease in 2012. To the extent SFL did consider it, however, he found that actual loss experience was below SFL's projections.<sup>190</sup>

Mr. Schwartz agreed that he had not used longer-term trends of 20 or more points in calculating his trend for non-catastrophe losses. He stated that even a "cursory examination" of the historical experience, however, showed there was a turning point in the data in late 2009 or early 2010. For that reason, he believed that it would be unreasonable to rely on longer-term trends. He also observed that State Farm (though not SFL) had alleged in a California proceeding that he preferred 12-point trends, while in this case SFL was claiming he generally preferred longer-term trends. Mr. Schwartz stated that the analysis of loss trends is a fact-specific determination.<sup>191</sup>

Mr. Schwartz acknowledged Ms. Frankowiak's criticism of his use of pure premium analysis alone rather than also considering frequency and severity of specific perils. He stated that his projections had nevertheless been more accurate and that SFL's projections of loss severity generally had been higher than the actual levels. He further stated that loss severity has been declining since December 2011 and that loss frequency has been declining since June 2010.<sup>192</sup>

In summary, Mr. Schwartz believed that, based on actual data, his 0% annual non-catastrophe loss trend was generous to SFL.

## 2. ALJs' Analysis

In its initial and reply briefs, OPIC did not advocate or discuss Mr. Schwartz's argument that data from after the rate case filing should be used to evaluate SFL's rates.<sup>193</sup> Indeed, Texas Insurance Code Chapter 2251 makes it clear that rate filings are to be prospective. The Code defines

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<sup>190</sup> OPIC Ex. 4 (Schwartz Rebuttal) at 9-10.

<sup>191</sup> OPIC Ex. 4 (Schwartz Rebuttal) at 10-13.

<sup>192</sup> OPIC Ex. 4 (Schwartz Rebuttal) at 14-18.

<sup>193</sup> OPIC Init. Brief at 2, 13-14; OPIC Reply Brief at 10-13.

“prospective loss cost” as based on “historical aggregate losses and loss adjustment expenses projected by development to the ultimate value of those losses and expenses and projected through trending to a future point in time.”<sup>194</sup> Under Texas Insurance Code § 2251.106, OPIC’s written objections are to address the insurer’s rate filing or the criteria on which the insurer relied to determine the rate. SFL could not have used data from the last two quarters of 2012 in its rate filing or as part of the criteria on which it relied, because those data were not available. The ALJs have not used the September 2012 and December 2012 data to determine non-catastrophe expense because they clearly were not available to SFL.

SFL argued also that the data from the first two quarters of 2012 should not be considered. The ALJs agree with OPIC on that issue. If the data were relevant and reasonably available to the insurer before the rate filing occurred, they should be considered, especially because such data may inform the insurer’s determination of prospective trends.

Having said that, the ALJs find that SFL’s estimate of non-catastrophe losses and LAE was not excessive or unreasonable. First, as Ms. Frankowiak testified, preparation of a rate filing is a long process. One of the first steps in that process is the determination of non-catastrophe loss expenses. SFL, or any insurer, cannot be expected to restart the process with every new quarter of data.

If new data were to show a trend of dramatic increases or decreases in losses, the insurer would be expected to consider that change in its projections. The data from the first quarter of 2012, whether available for analysis in April or May, did not show any dramatic increase or decrease. They were essentially the same as the previous quarter. Only in the second quarter of 2012 did the data show a noticeable decline.<sup>195</sup>

The evidence does not show that the second quarter decline in non-catastrophe losses, available to the preparers of the rate filing approximately six weeks to a month before the filing,

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<sup>194</sup> Tex. Ins. Code § 2251.002(3).

<sup>195</sup> OPIC Ex. 4 (Schwartz Rebuttal) at 6; Tr. at 433.

required a revision of SFL's projections. First, SFL had already lowered its projections from the 2011 results because it expected lower losses in 2012. Second, although shorter trend lines showed a projected decline in prospective expenses, longer trend lines showed an increase. While the parties agreed that non-catastrophe loss expenses had turned down beginning in late 2009 or early 2010, the evidence did not explain why they turned down or why that decline should have been expected to continue or become more precipitous.

### G. Operating Expenses

The Code provides that, in setting its rates, an insurer is entitled to include its "operating expenses, excluding disallowed expenses."<sup>196</sup> In its rate filing, SFL broke its operating expenses into three categories: (1) fixed expenses; (2) variable expenses; and (3) loss adjustment expenses (i.e., expenses related to the settlement of losses).<sup>197</sup> OPIC did not object to SFL's loss adjustment expenses. Therefore, this PFD addresses only fixed expenses and variable expenses.

#### 1. Fixed Expenses

As explained by SFL witness Frankowiak, fixed expenses are expenses that do not vary in direct proportion to premiums. Examples of fixed expenses would be employee salaries, marketing expenses, and the costs of facilities and supplies.<sup>198</sup> In its filing, SFL broke down its fixed expenses into two categories: (1) general expenses (GEs); and (2) other acquisition expenses (OAEs). GEs include items such as salaries, rents, and office expenses.<sup>199</sup> OAEs are expenses related to the acquisition of business, such as marketing, advertising, and sales promotions.<sup>200</sup>

To arrive at the projected value of GEs in its filing, SFL took the average of the annual GEs for SFL for the years 2009 through 2011 and then assumed that amount would increase by 1% per

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<sup>196</sup> Code § 2251.052(a)(5).

<sup>197</sup> SFL Ex. 3 (Frankowiak Direct) at 41.

<sup>198</sup> SFL Ex. 3 (Frankowiak Direct) at 42.

<sup>199</sup> Tr. at 61.

<sup>200</sup> SFL Ex. 3 (Frankowiak Direct) at 42.

year for the years 2012 through 2015. As to its OAEs, SFL took the average of its annual OAEs for the years 2009 through 2011 and then assumed that amount would increase by 5% in 2012 and then by 4% per year for the years 2013 through 2015.<sup>201</sup> Because OAEs are the largest component of fixed expenses, when the two categories of fixed expenses (OAEs and GEs) are combined, they would grow, according to SFL's filing, at a rate of roughly 3.5% per year after 2012.<sup>202</sup>

OPIC contends that SFL's assumed increases in GEs and OAEs are unreasonable because they are based upon "excessive inflation factors."<sup>203</sup> According to Mr. Schwartz, SFL's fixed expenses actually grew by 2.4% from 2009 to 2010, and by 1.4% from 2010 to 2011. When averaged, this equates to a growth rate of 1.9% over the 2009-11 period. Thus, Mr. Schwartz contends that a projected growth rate of 2% per year is more consistent with SFL's actual experience over recent history.<sup>204</sup>

Mr. Schwartz also cites to a document entitled "North Carolina Homeowners Insurance Determination of Trend for Expenses" as authority for the proposition that a 2% annual expense growth trend "is consistent with general economic conditions that impact the expenses of insurance companies."<sup>205</sup> This document concludes that a "selected annual change" of 2% is based on Bureau of Labor Statistics historical data, including historical annual changes in the Consumer Price Index (excluding energy) (CPI) and the Compensation Cost Index for Insurance Carriers, Agent Brokers, and Service (CCI).<sup>206</sup>

OPIC also introduced evidence it believes refutes SFL's contention that its OAEs will continue on an upward trend. Specifically, OPIC's counsel read into the record excerpts from a July 10, 2012 memo from a SFL employee regarding, among other things, the "expense trends" for the various SFL companies (which would presumably include SFL). The memo reads, in relevant

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<sup>201</sup> SFL Ex. 3 (Frankowiak Direct) at 42-43; SFL Ex. 1 (Filing) at 211; Tr. at 446-47.

<sup>202</sup> OPIC Ex. 3 (Schwartz Direct) at 18.

<sup>203</sup> OPIC Ex. 3 (Schwartz Direct) at 17.

<sup>204</sup> OPIC Ex. 3 (Schwartz Direct) at 18; Tr. at 62-63.

<sup>205</sup> OPIC Ex. 3 (Schwartz Direct) at Sched. AIS-4.

<sup>206</sup> OPIC Ex. 3 (Schwartz Direct) at Sched. AIS-4.

part, as follows: “In past years we have been increasing our marketing expenses by a substantial margin. However, this year we’re planning to keep our marketing spend [sic] very stable. There will be an increase soon to anticipated increases in bonuses.” The memo shows spending for marketing expenses between 2011 and 2012 was stable, while the expenses for bonuses were a bit larger for 2012 than for 2011. The memo concludes by recommending a 2% growth trend for GEs.<sup>207</sup> According to Mr. Schwartz, this memo confirms that SFL overestimated the projected growth in fixed expenses after 2011.<sup>208</sup>

Mr. Schwartz also examined SFL’s actual fixed expenses in 2011 and 2012 (as reported in the company’s Annual Statements) and determined that they grew by only 0.9%. In Mr. Schwartz’s opinion, this is additional evidence demonstrating that the company overestimated its projected fixed expenses.<sup>209</sup> According to Mr. Schwartz, by using an excessive inflation factor of 3.5% (rather than a 2% inflation factor as he recommends), SFL overstated its indicated rate level by \$5.54, or “about 0.7%.”<sup>210</sup>

As explained above, SFL assumed that its GEs would increase by 1% per year for the years 2012 through 2015, and its OAEs would increase by 5% in 2012 and by 4% per year for the years 2013 through 2015. According to Ms. Frankowiak, SFL’s actuaries based these assumptions upon the company’s future plans to increase its marketing, which would increase its future costs over the period of 2007 through 2011.<sup>211</sup> SFL takes the position that Mr. Schwartz relied on too short a time period (2009 through 2011) to evaluate what the company’s projected future OAEs might be. SFL points out that, from 2007 through 2011, its OAEs grew at an average annual rate of 7.8%. Similarly, during the six years from 2005 through 2010, SFL’s OAEs grew at an even faster rate of

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<sup>207</sup> Tr. at 580-83.

<sup>208</sup> Tr. at 584.

<sup>209</sup> OPIC Ex. 4 (Schwartz Rebuttal) at 36-37; Tr. at 585.

<sup>210</sup> OPIC Ex. 3 (Schwartz Direct) at 20.

<sup>211</sup> Tr. at 449-50.

11.3%.<sup>212</sup> Therefore, the company contends that it is reasonable to take a longer-term growth trend into account when estimating future projected costs.

Ms. Frankowiak opined that the approach to estimating the company's future projected fixed expenses was reasonable and performed in accordance with generally accepted actuarial standards. Pursuant to ASOP 29, *Expense Provisions in Property/Casualty Insurance Ratemaking*, "expense provisions should reflect the conditions expected during the time these policies or coverages are expected to be in effect and should include all expenses expected to be incurred in connection with the transfer of risk."<sup>213</sup> Even Mr. Schwartz conceded that it can be a good idea for a company to take into account its plans for the future when attempting to project future expenses.<sup>214</sup> According to Ms. Frankowiak, SFL's decision to include 5% and 4% increase factors for OAEs created more accurate future cost projections than Mr. Schwartz's projections based solely on the years 2009 through 2011.<sup>215</sup>

SFL also rejects Mr. Schwartz's reliance upon North Carolina statistics using CPI and CCI data. According to Ms. Frankowiak, the use of national statistics may be acceptable in the absence of company-specific data, but it is preferable to use company-specific data in cases, such as the present case, where such data is available.<sup>216</sup>

In response to the internal SFL memo discussed by Mr. Schwartz which indicates that marketing expenses will remain "stable" from 2011 to 2012, SFL makes several points. First, the company notes that marketing expenses are only one component of OAEs. In fact, in 2011, marketing expenses accounted for less than one third of total OAEs. Thus, the fact that marketing expenses remained stable does not prove that OAEs as a whole did not increase from 2011 to 2012. SFL further points out that the memo discussed by Mr. Schwartz also indicated that GEs would grow

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<sup>212</sup> SFL Ex. 1 (Filing) at 284, 301; SFL Ex. 3 (Frankowiak Direct) at 46, 83.

<sup>213</sup> SFL Ex. 2 (Kelley Direct) at 227.

<sup>214</sup> Tr. at 252.

<sup>215</sup> SFL Ex. 3 (Frankowiak Direct) at 43, 45; Tr. at 452.

<sup>216</sup> SFL Ex. 3 (Frankowiak Direct) at 45; Tr. at 449.

at 2%, which is greater than the 1% GE growth rate projected in SFL's filing. Thus, when GEs and OAEs are combined, an overstatement of expected increases in OAEs would be offset to some degree by an understatement of expected increases in GEs.<sup>217</sup> For these reasons, SFL asserts that its decision to select a: (1) a 1% growth rate for GEs; (2) a 5% growth rate for OAEs in 2012; and (3) a 4% growth rate for OAEs in the following years, was reasonable and supported by the relevant data.<sup>218</sup>

The ALJs conclude that OPIC failed to meet its burden to demonstrate that the approach taken by SFL as to its fixed expenses was unreasonable or excessive. Unlike the shorter-term average advocated by Mr. Schwartz, the longer-term trends indicate that the company's fixed expenses have grown considerably on a year-to-year basis. OPIC did not convincingly demonstrate that this trend is likely to change.

## 2. Variable Expenses

Variable expenses are expenses that vary in direct proportion to premiums, such that if premiums increase, then variable expenses also increase. Variable expenses consist of such things as premium taxes and agent commissions.<sup>219</sup> In its filing, SFL selected a variable expense ratio of 14.9%.<sup>220</sup> OPIC does not challenge SFL's choice of 14.9%.<sup>221</sup> The ALJs find that SFL's variable expense ratio is reasonable and not excessive.

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<sup>217</sup> SFL Brief at 102.

<sup>218</sup> SFL Ex. 3 (Frankowiak Direct) at 47.

<sup>219</sup> SFL Brief at 103.

<sup>220</sup> SFL Ex. 1 (Filing) at 197.

<sup>221</sup> Tr. at 88-89, 329; OPIC Init. Brief at 17. SFL and OPIC *do* disagree as to how much, in terms of dollars, SFL should earn per policy for its variable expenses. This, however, is merely a function of their disagreements over the other components of the premium, such as non-hurricane catastrophe losses, non-catastrophe losses, and so on. For example, SFL's indicated average premium per policy is \$1,794, and 14.9% of \$1,794 is \$267. OPIC's indicated average premium per policy is \$1,299, and 14.9% of \$1,299 is \$194. SFL Ex. 2 (Kelley Direct) at 336. Thus, even though both parties agree on a variable expense ratio of 14.9%, OPIC would simply apply that percentage to a smaller indicated average premium than would SFL.

## H. Premium Adjustments

In ratemaking, premium adjustments are made to compare the future expected costs to future expected premiums. The starting point for determining future premium is historical premium. However, there are factors, such as changes in premium volume, that cause future expected premium to be different from historical levels, even if rates are unchanged. In its rate filing, SFL adjusted the historical premium to what the expected premium would be if current rates remained in effect.<sup>222</sup> OPIC challenged two of SFL's premium adjustments, but did not propose revisions. The ALJs find SFL's premium adjustments were appropriate.

### 1. Parties' Evidence and Arguments

OPIC's witness, Mr. Schwartz, identified two issues regarding SFL's premium adjustments. First, Mr. Schwartz questioned the numerical value used by SFL to adjust the historical experience to the current rate level. SFL claimed its 2011 rate increase of 9.6% resulted in a premium change of 1.4%. The difference between the two is about -7.5%, but the loss elimination ratios identified by SFL for the year ending in December of 2011 averaged to only -5.1% (a difference of about -2.4%). Mr. Schwartz testified that SFL had failed to provide the underlying data and calculations to explain that difference. He stated that SFL should be required to demonstrate how it arrived at its net premium impact.<sup>223</sup>

Second, SFL selected a premium equivalence factor of 0.629 to calculate the inflation adjustment. Mr. Schwartz observed that the premium equivalence factor used in this filing was significantly lower than previous factors used by SFL. He noted that a lower premium equivalence factor results in a smaller projected premium and, therefore, a higher indicated rate level. Mr. Schwartz testified that SFL should be required to demonstrate how it arrived at the numerical value of 0.629.

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<sup>222</sup> SFL Ex. 3 (Frankowiak Direct) at 6-7; OPIC Ex. 1 at 233-34; SFL Ex. 1 at 199-200.

<sup>223</sup> OPIC Ex. 3 (Schwartz Direct) at 28-29.

Ms. Frankowiak addressed Mr. Schwartz's concerns on behalf of SFL. She pointed to several compilations of data included in the rate filing and provided to OPIC. Ms. Frankowiak testified that the data provided would allow TDI and OPIC to perform calculations to validate SFL's projections.<sup>224</sup>

With regard to Mr. Schwartz's first issue, Ms. Frankowiak stated Mr. Schwartz had failed to recognize that loss elimination ratios were applied to adjust the historical losses for years prior to 2011, in addition to 2011 itself. The ratios applied to the earlier years resulted in larger reductions than the 5.1% he calculated for 2011. Ms. Frankowiak also stated that adjustments were also made to incorporate changes to the distribution of SFL homeowners policies.<sup>225</sup>

With regard to Mr. Schwartz's second issue, Ms. Frankowiak explained that, at each annual policy renewal, the amount of dwelling coverage on the policy is increased to cover the impacts of inflation on replacement costs. Although an increase in coverage results in an increase in premium, a 1% increase in coverage would not necessarily result in a 1% premium increase. The "premium equivalence factor" adjusts the projected annual inflationary impact to the resulting impact to premium.

Ms. Frankowiak agreed with Mr. Schwartz that the factor used in this filing was 0.629, while the factor used in the 2011 filing was 0.709. She stated that it was reasonable for the factor to change between filings, however. Ms. Frankowiak explained that the "relativities" for amounts of insurance are multipliers applied to the base premium to calculate the premium for different amounts of coverage. Those relativities were compressed in SFL's September 2011 filing, to reduce the amounts by which the rate increased as the amount of dwelling coverage increased. Therefore, under the new rates, on average, an increase in coverage would result in a smaller rate increase than in the past. That change, in turn, mathematically would reduce the premium equivalence factor.<sup>226</sup>

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<sup>224</sup> SFL Ex. 3 (Frankowiak Direct) at 9-10; SFL Ex. 2 (Kelley Direct) at 249, 252, 281, 298-99, 325 and 328-29.

<sup>225</sup> SFL Ex. 3 (Frankowiak Direct) at 13; SFL Ex. 2 (Kelley Direct) at 209.

<sup>226</sup> SFL Ex. 3 (Frankowiak Direct) at 15.

Ms. Frankowiak believed Mr. Schwartz had raised no legitimate issues with SFL's premium adjustments and that SFL's adjustments were fully supported and appropriate.

Mr. Schwartz did not discuss Ms. Frankowiak's testimony regarding premium adjustments in his written rebuttal testimony. In his live testimony, he briefly reiterated his belief that SFL's premium adjustments were not adequately explained, but he did not specifically address Ms. Frankowiak's testimony on the subject.<sup>227</sup>

## 2. ALJs' Analysis

The ALJs find that Ms. Frankowiak fully explained the apparent discrepancies identified by Mr. Schwartz. Mr. Schwartz's criticism of the numerical value used by SFL to adjust the historical experience to the current rate level was unfounded, because adjustments also were made for years prior to 2011. The difference between the premium equivalence factor of 0.629 and previous factors was explained by the compression of the relativities in the current filing. Ms. Frankowiak's testimony on those issues was un rebutted. The ALJs find SFL's premium adjustments were fully supported and appropriate.

### I. Rate Distribution

As stated previously, SFL's filing would implement an overall rate increase of 20%. This increase will not, however, result in a uniform 20% rate increase for each of SFL's policyholders. Rather, the actual change in premiums will vary by policyholder based upon individual rate characteristics.<sup>228</sup> The rate changes implemented by SFL vary from -37.7% to +49.4% for homeowners policies and from -19.4% to +75.3% for tenant policies.<sup>229</sup> In general, the company's

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<sup>227</sup> OPIC Ex. 4 (Schwartz Rebuttal); Tr. at 42.

<sup>228</sup> SFL Ex. 2 (Kelley Direct) at 52.

<sup>229</sup> SFL Ex. 1 (Filing) at 4; SFL Ex. 2 (Kelley Direct) at 58-59.

filing increased overall rates, but it then offset that change to some extent by changing numerous discounts and rating factors.<sup>230</sup>

OPIC contends that these variations between policyholders are so great that they are “possibly” discriminatory.<sup>231</sup> Mr. Schwartz argues that SFL failed to justify the variations between its rates because the company provided only “very brief descriptions of the basis for the changes without providing the underlying data, calculations or analyses.”<sup>232</sup> Mr. Schwartz concludes that SFL “should be required to submit adequate support” for its rating change factors.<sup>233</sup> OPIC argues that, without this information, “it cannot be determined if the filed rates ‘bear a reasonable relationship to the expected loss and expense experience’ among the insured risks and result in [SFL’s] policyholders paying rates that are unfairly discriminatory.”<sup>234</sup>

SFL responded to Mr. Schwartz’s criticisms by pointing out that the various rate classifications which resulted in the disparity of rate changes were developed in accordance with standard actuarial practices.<sup>235</sup> As explained by Mr. Kelley, “Distinguishing among and classifying individuals in groups according to their risk characteristics for proper cost recognition is a fundamental actuarial principle of insurance ratemaking.”<sup>236</sup> Moreover, in imposing different rates on different policyholders, SFL’s goal was to achieve greater “rate equity” (i.e., to ensure that each policyholder’s premium more accurately reflects the risks that the policyholder faces).<sup>237</sup>

Mr. Kelley explained that, in the filing, SFL adjusted many of the variables that account for an individual policyholder’s premium such as: revising rate levels for each of the three homeowners policy types; revising rate “relativities”; revising numerous discounts, such as the home/auto

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<sup>230</sup> OPIC Ex. 3 (Schwartz Direct) at 30.

<sup>231</sup> OPIC Ex. 3 (Schwartz Direct) at 29.

<sup>232</sup> OPIC Ex. 3 (Schwartz Direct) at 31.

<sup>233</sup> OPIC Ex. 3 (Schwartz Direct) at 32.

<sup>234</sup> OPIC Init. Brief at 20 (*quoting* Code § 2251.051(d)(2)).

<sup>235</sup> SFL Ex. 2 (Kelley Direct) at 54.

<sup>236</sup> SFL Ex. 2 (Kelley Direct) at 55.

<sup>237</sup> SFL Ex. 2 (Kelley Direct) at 53-55.

discount; and revising base premiums by rating zones. Because such a large number of variables were revised in the filing, Mr. Kelley concluded, “It is not surprising that the resulting range of rate *changes* for individual policyholders is not [within] a tightly compressed range.”<sup>238</sup>

Mr. Kelley opined that the relatively large variation in rate changes among policyholders is not an indication of unfair discrimination but, rather, an indication of the fairness of the rates. According to Mr. Kelley, the whole point of imposing different rates upon different categories of policyholders is to ensure that riskier policyholders pay more for their insurance while less risky policyholders pay less. Because the rate changes help achieve this goal, Mr. Kelley believes they are equitable and not unfairly discriminatory.<sup>239</sup>

The ALJs conclude that OPIC failed to prove that the rate changes were unfairly discriminatory. Pursuant to the Code, SFL is prohibited from implementing rates that are “unfairly discriminatory.”<sup>240</sup> There are three ways that rates can be unfairly discriminatory:

- (1) If they are not based on sound actuarial principles;
- (2) If they do not bear a reasonable relationship to the expected loss and expense experience among risks; or
- (3) If they are based wholly or partly on the race, creed, color, ethnicity, or national origin of the policyholder or an insured.<sup>241</sup>

Only the second of these three possible ways of adopting unfairly discriminatory rates is implicated by OPIC. OPIC does not allege, for example, that SFL’s rates lack a sound actuarial basis, or that the rates are based on race, creed, color, ethnicity or national origin. Instead, OPIC

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<sup>238</sup> SFL Ex. 2 (Kelley Direct) at 57 (emphasis in original).

<sup>239</sup> SFL Ex. 2 (Kelley Direct) at 58-59.

<sup>240</sup> Code § 2251.052(b).

<sup>241</sup> Code § 2251.051(d).

alleges only that the rate changes between policyholders are unfairly discriminatory because they do not bear a reasonable relationship to the expected loss and expense experience among risks.<sup>242</sup>

On this issue, OPIC failed to meet its burden of proof. In its briefing, OPIC argues merely that the rate changes result in “extreme disparity” among policyholders, and that it “cannot be determined” whether the rates bear a reasonable relationship to the expected loss and expense experience among risks.<sup>243</sup> Mr. Schwartz testified only that the variation between the rate changes “could possibly” result in discriminatory rates.<sup>244</sup> The applicable law prohibits “unfairly discriminatory” rates. It does not prohibit rates that impose “extreme disparities” between policyholders, or rates that “could possibly result in discriminatory rates.” Likewise, the ALJs are unconvinced by OPIC’s argument that SFL “should be required to submit adequate support” for its rate changes. It is OPIC, not SFL, that bears the burden of proof in this case.<sup>245</sup> Thus, it was OPIC’s burden to prove that the rate changes were unfairly discriminatory; it was not SFL’s job to prove the opposite.

#### IV. CONCLUSION

The ALJs find that SFL’s rates were excessive for only one of the expense categories that were challenged by OPIC—contingency expense. Elimination of that expense would reduce SFL’s indicated rate by only \$36, which would still leave the indicated rate well above the actual rate implemented by SFL. Therefore, OPIC failed to prove SFL’s rates are excessive or unreasonable. OPIC also failed to prove SFL’s rates are unfairly discriminatory. The ALJs conclude that SFL’s rates meet the requirements of Chapter 2251 of the Code and should remain in effect.

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<sup>242</sup> SFL Ex. 8 (OPIC’s Application for Hearing) at 3.

<sup>243</sup> OPIC Init. Brief at 19-20.

<sup>244</sup> OPIC Ex. 3 (Schwartz Direct) at 29.

<sup>245</sup> Code § 2251.105.

## V. FINDINGS OF FACT AND CONCLUSIONS OF LAW

### A. Findings of Fact

#### Procedural History

1. State Farm Lloyd's (SFL) filed its Texas homeowners insurance rate with the Texas Department of Insurance (TDI or the Department) on September 7, 2012.
2. The Office of Public Insurance Counsel (OPIC) filed written objections to SFL's rate filing.
3. The Commissioner of Insurance reviewed SFL's filing and OPIC's objections and did not disapprove the filing.
4. SFL's rates went into effect for new policies on November 1, 2012, and for renewal policies on December 1, 2012.
5. In February 2013, OPIC sought a hearing on the rate under Texas Insurance Code (Code) § 2251.105(d).
6. Notice of the hearing was sent to the parties on February 12, 2013.
7. The notice contained a statement of the time, place, and nature of the hearing; a statement of the legal authority and jurisdiction under which the hearing was to be held; a reference to the particular sections of the statutes and rules involved; and a short, plain statement of the matters asserted.
8. The hearing in this case was convened before Administrative Law Judges (ALJs) Hunter Burkhalter and Henry D. Card on April 24, 2013, at the State Office of Administrative Hearings (SOAH).
9. The hearing was adjourned on April 26, 2013.
10. OPIC's reply brief was filed on June 20, 2013, on which date the record closed.

#### Rate-Setting Issues

11. SFL's indicated average premium per policy, as set forth in the rate filing, is \$1,794.
12. SFL's filed rate currently in effect is \$1,579 average premium per policy, which is \$215 below the indicated rate in its filing.
13. For OPIC to prove that the rate in effect is excessive, it must show that SFL's indicated rate is excessive by more than \$215.

14. Changes to individual cost categories would flow through to affect underwriting profit, contingency, and variable expenses—components that are themselves percentages of premiums.

*Non-Hurricane Catastrophe Losses and Loss Adjustment Expenses (LAE)*

15. A “catastrophe” is defined by the Actuarial Standards of Practice (ASOP) as “a relatively infrequent event or phenomenon that produces unusually large aggregate losses.”
16. Non-hurricane catastrophes include such phenomena as hailstorms, tornados, and wildfires.
17. In its filing, SFL used countrywide State Farm-company data, which included Texas data, to identify a 2% per year upward trend in non-hurricane catastrophe expenses and LAE per Amount of Insurance Year (AIY). It then applied that trend to Texas historical average catastrophe and LAE/AIY.
18. OPIC contended that the Texas-only data were sufficiently credible and should be used, that the Texas trend line was not statistically different from a flat line, and therefore a 0% trend should be used.
19. The difference per policy between OPIC’s and SFL’s positions for non-hurricane catastrophe expenses and LAE, before any flow-throughs to other expense categories, is \$120.
20. Texas is a large, particularly catastrophe-prone state.
21. The historical catastrophe data for Texas can and often do vary significantly from year to year.
22. “Credibility,” in the insurance ratemaking context, is a measure of the predictive value that an actuary attaches to a particular body of data.
23. The Texas-only data showed an actual trend of 1.1%.
24. If the Texas-only data were credible, OPIC should have used the indicated trend of 1.1%, rather than a 0% trend, in its rate calculations.
25. The Texas-only non-hurricane catastrophe loss data were not credible.
26. SFL properly considered data from outside Texas in determining the trend to be applied to non-hurricane catastrophe losses and LAE.
27. No adjustment should be made to SFL’s indicated rate in the non-hurricane catastrophe loss and LAE category.

**SFL's Use of Reinsurance**

28. During the time period relevant to its rate filing, SFL projects that it will annually spend \$347 million on reinsurance, and its net reinsurance costs will equate to roughly 10% of premiums.
29. Although a significant portion of SFL's reinsurance is purchased from an affiliate company, the rates charged by the affiliate to SFL are lower than market rates.
30. OPIC failed to prove that SFL's projected reinsurance costs are unreasonable.
31. Because SFL utilized the direct ratemaking method in this case, the company's reinsurance costs were not directly taken into account as a standalone expense item when the company's rate was calculated.

**The Unusually High Level of Risks Faced by SFL**

32. SFL faces an increased level of business risk because it issues almost exclusively homeowners policies in a single state, and the coverage includes catastrophe coverage in a catastrophe-prone state.
33. SFL is obligated to pay a large surplus note with an outstanding balance of \$500 million, with a final payment due by the end of 2016. The existence of this surplus note creates an elevated level of business risk for the company.
34. SFL is subject to an elevated level of regulatory risk in Texas, including a still-in-effect order from the Commissioner requiring it to pay refunds of roughly \$257 million.
35. Because SFL faces these various elevated levels of risk, it is entitled to obtain a correspondingly higher level of underwriting profit.

**Underwriting Profit**

36. In its filing, SFL proposed an underwriting profit provision of 20%, based on a model that contemplated a target surplus-to-premium ratio of 2.0 and a 9.6% GAAP Adjusted Return.
37. SFL's selection of a 9.6% GAAP Adjusted Return is reasonable and would not lead to excessive profits.
38. SFL's surplus-to-premium ratio of 2.0 represents a theoretical level of surplus in relation to premium, the company's actual surplus being much smaller.

39. Use of a theoretical, as opposed to actual, level of surplus-to-premium in deriving an underwriting profit provision is a widely accepted, and appropriate, practice.
40. It is reasonable to consider the existence of the surplus note, and the need for both the principal and related interest on that note to be paid by the end of 2016, when determining: (1) the level of risk faced by SFL during the rate period; (2) the appropriate theoretical cost of capital or surplus-to-premium ratio; and (3) the appropriate underwriting profit provision.
41. It is reasonable to consider the fact that SFL faces an increased level of business risk because it issues almost exclusively homeowners policies in a single state, and the coverage includes catastrophe coverage in a catastrophe-prone state, when determining: (1) the level of risk faced by SFL during the rate period; (2) the appropriate theoretical cost of capital or surplus-to-premium ratio; and (3) the appropriate underwriting profit provision.
42. It is reasonable to consider the fact that SFL is subject to an elevated level of regulatory risk in Texas, including a still-in-effect order from the Commissioner requiring it to pay refunds of roughly \$257 million, when determining: (1) the level of risk faced by SFL during the rate period; (2) the appropriate theoretical cost of capital or surplus-to-premium ratio; and (3) the appropriate underwriting profit provision.
43. SFL's selection of a surplus-to-premium ratio of 2.0 was reasonable and appropriate in light of the elevated risks faced by the company.
44. In the absence of reinsurance, SFL would need to maintain roughly \$2 of surplus for every \$1 of premium (i.e., a surplus-to-premium ratio of 2.0) in order to have sufficient funds available to pay all claims in the event of a major catastrophe on the order of something that occurs only once in 100 years.
45. Rather than maintaining an actual surplus-to-premium of 2.0, SFL maintains a smaller surplus and "rents" the additional surplus in the form of reinsurance to achieve the equivalent of a 2.0 surplus-to-premium ratio.
46. SFL's selection of a surplus-to-premium ratio of 2.0 to calculate its underwriting profit provision was reasonable and appropriate in light of the reinsurance costs paid by the company.
47. Even though SFL's reinsurance costs were not directly considered by the company as an expense item, they are a legitimate cost of capital to the company and, therefore, it is appropriate to take those costs into account when calculating the company's underwriting profit.
48. OPIC failed to prove that the 20% underwriting profit provision included in SFL's filing is unreasonable or excessive.

Contingency

49. SFL calculated a 2% contingency provision in its indicated rate increase.
50. A contingency provision is warranted if there is some bias or systematic variation in the ratemaking process.
51. Several of the factors that may cause a systematic variation in the ratemaking process, such as adverse court decisions, legislative changes, and regulatory actions, are often peculiar to the particular jurisdiction in which the insurer provides coverage.
52. Because the factors that may cause variations between expected and actual costs can be so jurisdiction-specific, State Farm's contingency study, which summarized State Farm's experience in 46 jurisdictions other than Texas, is of limited value in determining whether there is likely to be a systematic underrecovery for SFL.
53. The profit/loss data from Texas from 1989-2011 provided by SFL do not show a systematic pattern of underrecovery, excluding the effects of the mold issue that affected SFL's losses beginning around the year 2000.
54. Inclusion of a contingency provision for Texas in SFL's indicated rates is not justified.
55. Exclusion of the contingency provision would reduce SFL's rate indication by \$36.

Non-Catastrophe Losses and LAE

56. Non-catastrophe losses include all losses other than catastrophe losses—"typical" losses such as thefts, accidents on a homeowner's property, and house fires.
57. SFL projected its non-catastrophe losses based on its historical data through December 31, 2011.
58. SFL's projected non-catastrophe loss per policy, as set out in the rate filing of September 7, 2012, is approximately \$352.
59. OPIC contended that SFL, at the time of the rate filing, had data available through June 2012, which should have been used.
60. OPIC's approach yielded a projected loss per policy of \$326, a decrease of \$26 from the rate indicated in the rate filing.
61. Data from the first two quarters of 2012 were available to SFL before the rate filing was made.

62. Because the data from the first two quarters of 2012 were relevant and reasonably available to the insurer before the rate filing occurred, they may be considered.
63. Preparation of a rate filing is a long process. One of the first steps in that process is the determination of non-catastrophe loss expenses.
64. SFL, or any insurer, cannot be expected to restart the preparation of its rate filing with every new quarter of data.
65. If new data were to show a trend of dramatic increases or decreases in losses, the insurer would be expected to consider that change in its projections.
66. The first-quarter 2012 data, whether they were available for analysis in April or May, did not show any dramatic increase or decrease. They were essentially the same as the data from the previous quarter.
67. Only in the second quarter of 2012 did the data show a noticeable decline.
68. In preparing its rate filing, SFL lowered its non-catastrophe loss projections from the 2011 results because it expected lower losses in 2012.
69. If the first and second quarter 2012 data are considered, although shorter trend lines showed a projected decline in prospective expenses, longer trend lines showed an increase.
70. The shorter trend lines should not be used exclusively to determine future non-catastrophe losses.
71. The second quarter 2012 decline in non-catastrophe losses, available to the preparers of the rate filing approximately six weeks to a month before the filing, did not require a revision of SFL's projections.
72. SFL reasonably used data through December 31, 2011, in its rate filing.
73. SFL's estimate of non-catastrophe losses was not excessive or unreasonable.
74. No adjustment should be made to SFL's projected non-catastrophe losses.

**Fixed Expenses**

75. In its filing, SFL broke down its fixed expenses into two categories: (1) general expenses (GEs); and (2) other acquisition expenses (OAEs).
76. To arrive at the projected value of GEs, SFL averaged its annual GEs for the years 2009 through 2011 and then assumed that amount would increase by 1% per year for the years 2012 through 2015.

77. To arrive at the projected value of its OAEs, SFL averaged its annual OAEs for the years 2009 through 2011 and then assumed that amount would increase by 5% in 2012 and by 4% per year for the years 2013 through 2015.
78. Because SFL's OAEs are the largest component of the company's fixed expenses, when the two categories of fixed expenses (OAEs and GEs) are combined, they would grow at a rate of roughly 3.5% per year after 2012.
79. The approach used by SFL to estimate its future projected fixed expenses was reasonable and performed in accordance with generally accepted actuarial standards.
80. OPIC failed to meet its burden to demonstrate that the approach taken by SFL as to its fixed expenses was unreasonable or excessive. The longer-term trends indicate that the company's fixed expenses have grown considerably on a year-to-year basis. OPIC did not convincingly demonstrate that this trend is likely to change.

#### Variable Expenses

81. In its filing, SFL selected a variable expense ratio of 14.9%. OPIC does not challenge SFL's choice of 14.9%.
82. The approach used by SFL to estimate its future projected fixed expenses was reasonable and performed in accordance with generally accepted actuarial standards.

#### Premium Adjustments

83. In ratemaking, premium adjustments are made to compare the future expected costs to future expected premiums.
84. In its rate filing, SFL adjusted the historical premium to what the expected premium would be if current rates remained in effect.
85. SFL applied loss elimination ratios to years prior to 2011, in addition to 2011, to adjust its historical losses to the current rate level.
86. In adjusting losses, SFL also made adjustments to incorporate changes to the distribution of SFL homeowners policies.
87. SFL adequately explained and supported the numerical value SFL used to adjust the historical experience to the current rate level.
88. The premium equivalence factor used in this filing was 0.629, while the factor used in SFL's 2011 filing was 0.709.

89. The “relativities” for amounts of insurance are multipliers applied to the base premium to calculate the premium for different amounts of coverage. Those relativities were compressed in SFL’s 2011 filing to reduce the amounts by which the rate increased as the amount of dwelling coverage increased.
90. Under the 2011 filing, on average, an increase in coverage would result in a smaller rate increase than in the past. That change, in turn, reduced the premium equivalence factor.
91. SFL adequately explained and supported the rate filing’s premium equivalence factor of 0.629.
92. SFL’s premium adjustments were fully supported and appropriate.

**Rate Distribution**

93. Although SFL’s filing implements an overall rate increase of 20%, this increase will not result in a uniform 20% rate increase for each of SFL’s policyholders. Rather, the actual change in premiums will vary by policyholder, based upon individual rate characteristics, from -37.7% to +49.4% for homeowners policies and from -19.4% to +75.3% for tenant policies.
94. The various rate classifications that resulted in the disparity of rate changes were developed in accordance with standard actuarial practices.
95. In imposing different rates on different policyholders, SFL’s rate filing achieves greater rate equity by ensuring that each policyholder’s premium more accurately reflects the risks that the policyholder faces.
96. OPIC failed to prove that the rate changes were unfairly discriminatory.
97. Even after accounting for any changes to SFL’s rate as justified by the evidence, that modified indicated rate is still higher than the actual rate currently charged by SFL under the rate filing in issue.

**B. Conclusions of Law**

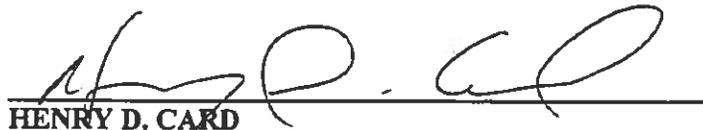
1. The Commissioner of Insurance has jurisdiction over this matter. Tex. Ins. Code ch. 2251.
2. SOAH has authority to hold a hearing this matter and render a proposal for decision containing findings of fact and conclusions of law. Tex. Ins. Code § 40.002 and Tex. Gov’t Code § 2003.021.

3. All parties received proper and timely notice of the hearing. Tex. Gov't Code §§ 2001.051 and 2001.052.
4. SFL's use of countrywide data to determine its non-hurricane catastrophe loss expenses and LAE was in compliance with the rate standards set out in Texas Insurance Code § 2251.052(a).
5. The contingency expense provision set out in SFL's rate filing did not meet the requirements of Actuarial Standard of Practice (ASOP) No. 30.
6. Data that was not available to SFL when the rate filing occurred should not be considered in determining SFL's non-catastrophe loss expense. Tex. Ins. Code ch. 2251.
7. SFL's rates must permit it to earn a reasonable rate of return on its investment, and the return should be commensurate with return on investment in other enterprises having corresponding risks.
8. SFL calculated its underwriting profit provision in compliance with the rate standards set out in Texas Insurance Code § 2251.052(a) and ASOP No. 30.
9. SFL's rates are not excessive, unreasonable, or unfairly discriminatory within the meaning of Texas Insurance Code § 2251.052(b).

**SIGNED August 19, 2013.**



**HUNTER BURKHALTER  
ADMINISTRATIVE LAW JUDGE/MEDIATOR  
STATE OFFICE OF ADMINISTRATIVE HEARINGS**



**HENRY D. CARD  
ADMINISTRATIVE LAW JUDGE  
STATE OFFICE OF ADMINISTRATIVE HEARINGS**

# ATTACHMENT A

