

**SB 14 Update:**

## **The Insurance Industry and Homeowners Adapt to a New Regulatory Framework**

In the year following the enactment of major insurance legislation in 2003, many Texas homeowners are getting some relief from previously skyrocketing property insurance premiums, while homeowners insurers have shown profits during the same period. But overall rates have not dropped as much as many expected, and two of the state's largest insurers are challenging rate cuts in court, denying immediate relief to more than 40 percent of the state's policyholders. At a June 16 news conference, Lt. Gov. David Dewhurst and Sen. Troy Fraser (R-Horseshoe Bay), accused the two companies – State Farm Lloyds and Farmers – of using stalling tactics to avoid state-ordered rate cuts and suggested that the Legislature may need to enact stiffer penalties to discourage such behavior.

Between 2000 and 2003, homeowners insurance premiums in Texas, which already were the highest in the nation, increased dramatically. According to the Texas Department of Insurance (TDI), premiums on a typical home increased from \$1,000 in 2000 to \$1,446 in early 2003, an increase of nearly 45 percent. Insurance

companies claimed that harsh Texas weather and excessive mold claims had driven up insurance losses, which resulted in higher rates. Consumer groups contended that the increases were the result of insufficient regulation of homeowners insurance companies, 95 percent of which were not subject to state rate regulation, and stemmed more from company investment losses in a plunging stock market than a significant increase in payouts. Citing heavy losses, two of the state's largest insurers stopped

writing new policies, and one threatened to withdraw from the state altogether. Responding to the surge in mold-related claims, the insurance commissioner approved a mandatory policy endorsement that capped coverage for mold remediation in standard homeowners policies at \$5,000.

The homeowners insurance crisis prompted the 78th Legislature to overhaul homeowners and auto insurance regulation in Texas with

**(See Insurance, page 2)**

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## **Alternatives for Expanding Texas' Water Supplies: Conservation**

*This article is the second in a two-part series about potential strategies to meet Texas' water needs. The first article, "Alternatives for Expanding Texas' Water Supplies: Desalination," HRO Interim News Number 78-8, August 20, 2004, examined the role desalination might play in state water policy. This article looks at conservation as a strategy to reduce demand on water supplies.*

In an address on August 5, 2004, to the American Membrane Technology Association in San Antonio, Gov. Rick Perry outlined four goals for the state in terms water policy: finding new sources of water; developing innovative financing tools for the construction of water projects; protecting the state's supply of water from sabotage; and improving water conservation practices. The last

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the enactment of SB 14 by Jackson. The bill made all personal auto and residential homeowners insurers, including those whose rates previously were unregulated, subject to “rate standards” requiring that all rates be just, fair, reasonable, adequate, not confiscatory, not excessive and not unfairly discriminatory. The bill also established a new rating system for regulating premium charges, allowed insurance companies to use their own policy coverage forms, and set criteria for use of credit scoring and territory rating.

A seven-member Property and Casualty Legislative Oversight Committee is monitoring the progress of insurance regulation revisions mandated by SB 14. By November 15, 2004, the committee is required to report to the governor, lieutenant governor, and House speaker about any problems that have arisen as a result of the changes and to recommend legislative actions needed to address these problems.

**Rate reductions**

By July 1, 2003, residential property insurers were required to file their rates with the insurance commissioner, who had 60 days to approve, reject, or modify the rates and could order refunds or credits if rates were found to be excessive. In August 2003, the commissioner ordered 37 companies to reduce rates by a total of \$510 million, which amounted to an overall reduction of 12 percent.

Allstate, one of the state’s largest property insurers, agreed to reduce rates by 10.1 percent in August 2003, with an additional 8.75 percent reduction in 2004 if a state review of the most recent rate data supported the additional rate cut. In August 2004, Allstate announced that it would issue refunds of \$60 million to 686,000 customers with policies in effect from September 7, 2003, through September 6, 2004, thus complying with the additional 8.75 percent ordered rate reduction. Five other insurers made similar agreements with TDI. Allstate has filed a request with TDI to cut rates by an additional 1.9 percent.

**Figure 1: Ordered rate cuts**

Company	2003	2004
Allstate	10.1%	8.75%*
American National	12	
American Standard	10	
Amica	12	
Chubb	4	
Continental Lloyds	9.8	9.8*
Consolidated Lloyds	8.35	8.35*
Foremost	20	
Hanover	31	
Hartford	9	
Horace Mann	18	
Kemper	6.5	6.5*
Liberty	7	
Metropolitan	22	
National	8	
Nationwide	11.6	
Republic	7	13*
SAFECO	15	
Texas Farm Bureau	1.5	
Travelers	11.2	
Trinity Lloyds	9.5	
USAA	7	

*\*2004 rate reductions part of 2003 agreement with TDI*

Two of the state’s largest property insurers – State Farm Lloyds and Farmers – were ordered to cut their rates by 12 percent and 17.5 percent respectively. These companies filed appeals in state district court claiming that the new statute and TDI’s method of determining the rate cuts violated the companies’ constitutional and statutory due process rights. A hearing in Travis County District Court is scheduled for October 18, 2004, before State District Judge Suzanne Covington to consider these issues.

Lawmakers and consumer groups have expressed frustration that these companies' policyholders have been denied rate relief because the companies are not required to reduce their rates while the order is appealed. The companies have responded that they are exercising their right to appeal rate decisions as outlined in SB 14. If the appeal is unsuccessful, the companies will have to refund to customers the amount they have collected over the state-ordered rate, plus interest of the prime rate plus 1 percent.

State Farm and Farmers insure more than 40 percent of the Texas market, and their ordered rate cuts together account for \$243 million, or nearly half, of the \$510 million in rate cuts ordered in 2003. Because these companies have not complied with the order, TDI estimates the overall rate decrease at about 4 percent.

Over the past year, insurance industry profits have rebounded, with loss ratios near their lowest levels in more than a decade (see Fig. 2, page 4). The industry's return to profitability has fueled calls for additional rate cuts. Consumer groups say that insurers should pass on at least a portion of these recent profits to policyholders in the form of lower rates. Insurers respond that it is too early to reduce rates further because a major weather event, such as a hailstorm or hurricane, still could affect overall industry profitability.

At an August 24 meeting of the House Insurance Committee, Rod Bordelon, who heads the Office of Public Insurance Counsel, a state agency that advocates on behalf of insurance consumers, told committee members that based on recent insurance industry profits, current rates are excessive and additional reductions will be needed even after the 2003 ordered rate cuts have taken effect. Bordelon acknowledged that it would be reasonable to wait until early 2005 to further reduce rates to allow for the possibility of weather events in late 2004 that could affect overall industry profits.

## New rating system

The rate reviews mandated by SB 14 were part of a transition to a new system for setting homeowners and auto insurance rates in Texas. Prior to the enactment of

SB 14, the state used a "benchmark" system to set rates for regulated companies. Under this system, the insurance commissioner established a benchmark rate, and companies were allowed to charge rates within a set range above or below the benchmark.

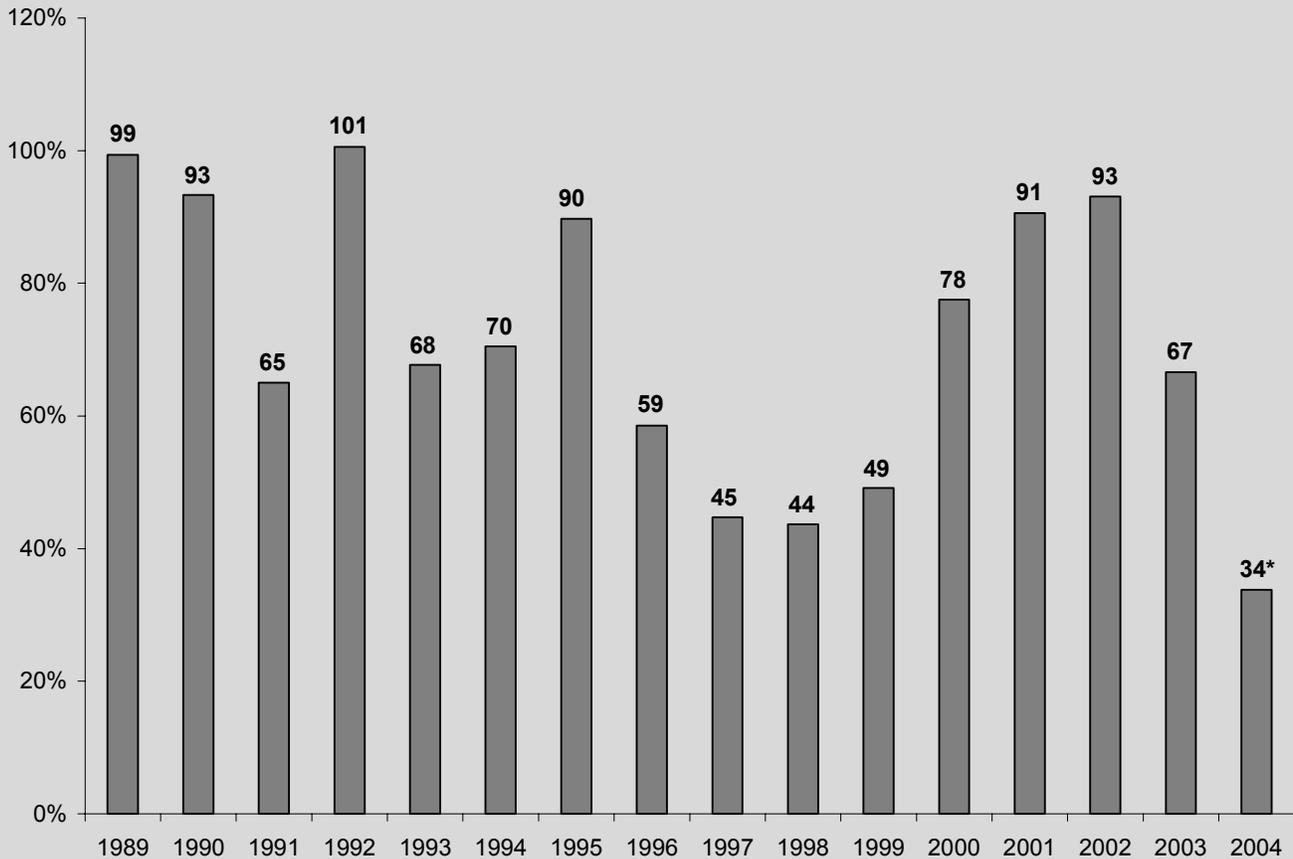
Insurers considered the benchmark rating system, established in 1991, to be excessively restrictive, and many responded by transferring business to unregulated companies. By 2003, about 95 percent of homeowners insurance policies and nearly one-third of auto insurance policies were sold through unregulated companies and therefore were not subject to the benchmark rating system. Under SB 14, all auto and property insurers doing business in Texas, including those that previously had escaped regulation, initially were required to submit rate data for review and approval by the insurance commissioner as part of a transition to a "file-and-use" system.

Beginning December 1, 2004, all Texas auto and property insurers will be subject to a file-and-use rating system, under which insurers can file rates that take immediate effect unless subsequently revised by the commissioner for failing to meet rating standards. Supporters of the file-and-use system said it is an acceptable compromise between the extremes of tighter regulation and total deregulation. Moving to this system will bring rates down initially, they said, and then create a competitive environment in which companies can file rates based on their actual costs, not on an artificial benchmark established by TDI. Opponents said it will give companies too much freedom in setting their own rates and that the state instead should move to a more restrictive system in which TDI must review and approve, and insurers must justify, every rate filing.

## Form deregulation

Another issue in the insurance regulation debate has been the use of forms that establish the content and coverage of policies. Previously, the state required all auto and homeowners insurers to use state-promulgated forms. Until recently, most homeowners bought an HO-B policy, which covered replacement costs for most kinds of damage. Insurers claimed that national companies used

**Figure 2: Texas homeowners insurance paid loss ratios  
1989-2004**



\* partial year

Source: Chart prepared by the Office of Public Insurance Counsel using TDI data

Industry loss ratios – a key barometer of industry profitability – are determined based on the percentage of premiums used to cover property losses. For example, a loss ratio of 58 means that the industry paid out 58 percent of premiums to cover property losses. Insurance industry experts regard a loss ratio below 60 percent as a general indication of profitability.

In the first half of 2004, paid loss ratios for Texas property insurers were the lowest they have been in a decade. The loss ratios expressed in this chart do not include operating expenses, loss adjustment expenses, or investment income.

national forms in every state except Texas, which was the only state to use the HO-B form, distorting economies of scale and resulting in higher costs for Texas consumers. In 2002, TDI began to approve the use of certain national policy forms for large companies only. SB 14 continued this process by allowing existing and new companies of any size to use their own forms. The commissioner may reject any form that does not provide fair and reasonable coverage. Supporters said greater form flexibility will attract more companies to do business in Texas and ultimately will benefit consumers by giving them greater choice and lower costs. Opponents said the varying levels of coverage offered in different policies can complicate the process of comparing policies when shopping for insurance.

According to TDI, between June 11, 2003, and July 26, 2004, the agency approved 13 new forms for personal auto and eight new forms for homeowners insurance, as well as more than 120 policy endorsements (attachments to a policy to add or reduce coverage). More than 50 insurer groups had notified TDI that they plan to use personal auto and homeowners insurance forms approved before the enactment of SB 14.

## Credit scoring

In addition to insurance rates, SB 14 allowed the use of credit scoring – taking a consumer’s credit history into account – in the pricing and sale of insurance policies. Supporters said using reliable predictors such as credit scoring to assign risks helps insurers to price their policies more accurately, ultimately creating more equitable insurance rates for all consumers. Opponents sought to ban the practice altogether, claiming that no independent study has proven a statistical relationship between a person’s credit history and the likelihood of filing insurance claims. Opponents also said credit scoring is discriminatory, especially against women, minorities, and low-income consumers, and that credit reports often contain errors that can take months to fix.

SB 14 allows insurers to consider credit scores in determining rates for residential, auto and noncommercial policies covering boats and other recreational vehicles. Credit scoring can be used to set premiums on the basis of a consumer’s credit history but cannot be used solely

to deny, cancel, or decline to renew a policy, and insurers may not discriminate on the basis of lack of credit.

SB 14 required insurers to file credit-scoring models with the commissioner and stipulated that these models are not subject to “trade secret” exceptions to public disclosure. TDI currently is using selected models as part of a comprehensive study to determine the correlation between credit scoring and rate setting.

Insurers are required to notify applicants for coverage that a credit report may be used in determining whether to offer coverage and in setting rates. If a policy is issued, an insurer is not required to make this disclosure on any subsequent renewals. TDI adopted rules (28 TAC sec. 5.9940), effective November 30, 2003, requiring insurers to issue forms indicating whether or not credit information will be used as part of the insurance credit scoring process.

SB 14 also requires TDI to establish by rule the allowable differences in rates due solely to the difference in credit scores. The insurance commissioner adopted a rule (28 TAC sec. 5.9941), effective November 30, 2003, requiring that rate differences based on credit scores be based on sound actuarial principles and supported by data filed with the department. When the rule was proposed initially, opponents said it failed to comply with a clear legislative mandate to set a cap on the amount that rates can be increased based on credit information. In response to these comments, TDI subsequently filed a proposed amendment to the rule that would prohibit rate differences of more or less than 10 percent due solely to the use of credit scoring. An insurer that wished to exceed this limit would have to request and justify an allowable difference in rates and could not use that proposed rate until it was permitted by the department. The proposed amendment currently is pending.

## Territory rating

SB 14 prohibited insurers from dividing counties into smaller territories for purposes of determining rates for personal auto and homeowners insurance if the rates in one part of a county were more than 15 percent higher

than rates in another part of the county. This provision, which was introduced as an amendment to SB 14 by Rep. Sylvester Turner (D-Houston), was intended to discourage insurance redlining by limiting differences in rates for similar coverage within large cities, such as Houston and Dallas. Redlining is the practice of denying or increasing the cost of insurance to residents of certain areas on the basis of race, ethnicity, economic status, or religion. The bill authorized the insurance commissioner to adopt rules to allow for greater rate differences.

In November, 2003, the insurance commissioner approved a rule allowing insurers to exceed the 15 percent limit if the rate is based on sound actuarial principles, is supported by data filed with the

department, and is in compliance with all statutory and regulatory requirements. Supporters said the rule would ensure that homeowners in inland areas of a large county would not have to subsidize the catastrophic wind exposure of property owners along the coast. Opponents said the rule goes against the intent of SB 14, which was to address the problem of redlining in large cities by limiting the effect of territory rating factors even if they are actuarially justified. If an exception needed to be made for wind damage along the coast, opponents said, TDI should have made a specific provision for this, rather than allowing all insurers to exceed the 15 percent limit in any situation that could be actuarially justified.

— *by Betsy Blair*

**(Conservation, from page 1)**

strategy – conservation – lately has received a great deal of attention from state officials. Most recently, the 78th Legislature in 2003 considered more than a dozen bills and enacted several laws related to stretching existing water supplies through conservation.

Among these new laws was SB 1094 by Duncan, which created a water conservation task force to provide recommendations to the Legislature on how best to address conservation for the entire state. This report, scheduled for release by November 1, 2004, represents the increased emphasis placed on conservation by many lawmakers and water policy experts. While water conservation is not new to Texas, this attempt to coordinate conservation efforts across the state into a major strategy to address water needs likely will raise the profile of water conservation initiatives in the 79th Legislature.

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*One "acre-foot" of  
water equals  
326,000 gallons.*

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**The role of conservation in state water planning**

The Texas Water Development Board's (TWDB) 2002 State Water Plan estimates that by 2050 the state's population will nearly double to approximately 40 million. While population growth certainly will generate increased demand for water, the limited supply of water in the state's streams, aquifers, and reservoirs requires that demand increase at a rate slower than population growth. The State Water Plan dictates that by 2050 the consumption of water by municipal, agricultural, and other interests can increase only 15 percent over the current level of 16.9 million acre-feet to approximately 20 million acre-feet.

Water conservation – a strategy that focuses on reducing demand for water by consumers – features prominently in TWDB's plan. Conservation is expected to provide 13.5 percent of the volume of water that the state's expanded population will need in 2050, while desalination, by contrast, is expected to account for 2.5 percent of that volume. Total conservation under the plan will save approximately 2 million acre feet per year by 2050, of

which approximately 976,000 will come from more efficient plumbing fixtures, 867,000 from agricultural conservation projects, and 68,000 from municipal conservation projects. Although the plan is relatively specific in terms of targets for conservation, water policy officials have begun to recognize the need for more specificity and coordination in terms of how these goals will be met.

**Conservation at the local level.** Several cities in Texas have developed conservation programs to promote water-saving practices among their residents and businesses. Two leaders in this regard are the City of Austin and the San Antonio Water System. While the reasons behind the need to promote conservation are somewhat different in each city, Austin and San Antonio have pursued similar conservation strategies. In Austin, the rapid population growth that has occurred since the 1990s is expected to continue in the future, a fact that will increase pressure on the capacity of the city's water treatment plants. Because construction of additional water treatment facilities would represent a substantial cost, more efficient use of the volume of potable water produced in the city would reduce future water treatment expenses.

While San Antonio also faces population growth in the coming years, its need for water conservation is all the more urgent because the city can pump only a limited amount of water from its primary water source, the Edwards Aquifer. Improved efficiency in water usage will lessen San Antonio's need to purchase water from other parts of the state, an expensive prospect that also could be politically controversial.

Conservation programs in Texas cities are multi-faceted. Several cities provide various rebates or incentives for consumers to retrofit old, inefficient appliances, such as toilets and washing machines, with new models that require less water. For example, Austin provides free low-flow toilets to residents and commercial customers to replace older toilets that were installed prior to the federal Energy Policy Act of 1992 mandate that new toilets use no more than 1.6 gallons per flush. Other cities provide similar rebates.

## Water conservation and brush control

The Brush Control Assistance program is designed to increase water flows in specific watersheds by removing certain water-depleting plants from rangeland. According to the U.S. Department of Agriculture, brush and trees such as mesquite, juniper, and cedar drain more than 3.5 trillion gallons of water per year from watersheds in Texas. In order to reduce water loss from these plants, the State Soil and Water Conservation Board (SSWCB) administers cost-share programs with local conservation districts and landowners to control brush in several regions of the state.

The Legislature appropriated \$4 million in general revenue and \$11.3 million in unexpended balances from water conservation bonds for the Brush Control Program in fiscal 2004-05. In fiscal 2002-03, the program was appropriated \$9.2 million in general revenue and \$15 million in bond funds. With these funds the board has conducted brush control feasibility studies in several river basins and has provided grants to local conservation districts for brush control projects.

According to its 2003 annual report, the SSWCB's Brush Control Program has treated 388,545 acres on eight mesquite and juniper projects throughout the state. These projects are expected to yield a total of 503,446 acre-feet of water over 10 years. The average cost of water recovered through these projects is approximately \$60 per acre-foot. The SSWCB also has two salt cedar control projects in which the board partners with the United States Natural Resources Conservation Service.

Several cities also provide public education on the virtues of conservation as well as techniques for home and business owners to save water. For example, both Austin and San Antonio offer individualized audits to educate residents, businesses, and apartment managers about efficient landscape irrigation and water use practices. A

In March 2004, the State Auditor's Office (SAO) issued a report criticizing the SSWCB's administration of the brush control cost share program because payments approved by local soil and water conservation districts lacked oversight by the state board. For example, the SAO report pointed to an instance where a landowner reimbursed himself more than \$100,000 in state funds for work he performed as part of the Brush Control Program. SSWCB resolved to develop additional controls to manage such situations more effectively.

Supporters of the Brush Control Program argue that it is an excellent way to increase stream flows and reservoir levels across the state. They argue that the reduction in general revenue for brush control in fiscal 2004-05 undermined a program shown to produce water for around \$60 per acre-foot, while water from many other water development projects often costs much more. They say that a carefully tailored, site-specific approach to brush control is most effective, and that new strategies, such as the use of herbicides and importation of insects to kill exotic weeds, could reduce the cost of thinning unwanted plants in the future.

Opponents say that brush control is too costly to warrant the significant investment required to make it cost-effective. The state should focus its money on better proven technologies, such as desalination and reservoir construction, rather than paying individual landowners to clear brush on their own land. Others fear that the widespread use of herbicides may contaminate the very water that brush control activities seek to conserve.

number of cities also have established drought management plans to regulate water use in times of limited supply. El Paso Water Utilities, for example, has a three-tier drought management plan that introduces variously restrictive requirements on homes and businesses as drought conditions worsen.

## Water conservation bills in the 78th Legislature

**Proposals that failed to pass.** The 78th Legislature considered HB 487 by Puente, a bill that was placed on the General State Calendar but was not considered on the House floor. It would have required a newly installed or modified irrigation system to have a rain shutoff device to override the irrigation cycle of the system when a certain amount of rain had fallen.

Two water conservation proposals that died in the Calendars Committee in the 78th Legislature dealt with performance standards for appliances. HB 488 by Puente would have required that the maximum flush flow of toilets sold in the state be no more than 2 gallons per flush if a replacement flapper was installed. Studies have shown that installation of the wrong type of replacement flapper on water-efficient toilets can significantly undermine projected water savings. HB 489, also by Puente, would have prohibited the sale or lease of a commercial washing machine unless it met specified water and energy efficiency standards.

**New laws.** Among the bills enacted by the 78th Legislature was HB 645 by Puente, which prevents homeowner or property owner associations from enforcing certain restrictions on homeowners that could undermine water conservation initiatives. Among other provisions, the law prohibits a homeowner's association from preventing a property owner from using a rainwater harvesting system or installing drip irrigation systems. Supporters of HB 645 said that it would allow homeowners to choose water-efficient landscape practices without the threat of punitive fines by their homeowners' associations. Opponents said that the bill would undermine the authority of homeowners' associations to ensure a minimum level of maintenance to properties under their jurisdiction.

In addition, the 78th Legislature also enacted HB 2660 by Puente, which requires all regional water conservation plans mandated by the state to include specific five- and 10-year targets for water savings. Supporters of the bill said that such a requirement is necessary because many cities have offered only vague or insufficient outlines of their water conservation plans.

The Legislature also addressed conservation in the agriculture industry by enacting SB 1053 by Duncan. This law consolidated several of TWDB's financial assistance programs into an Agricultural Water Conservation Fund. In February 2004, TWDB initiated a process to consider agricultural water conservation demonstration programs to be funded through the program. At a press conference on September 22, 2004, TWDB chairman Rod Pittman announced that the board would fund two water conservation demonstration projects to test and employ new irrigation and other technologies designed to improve water use efficiency in agriculture. Of the two projects TWDB authorized, one was submitted by group of applicants that includes Texas Tech University. This project will provide up to \$6.2 million for a demonstration project east of Plainview designed to identify agricultural and irrigation practices to conserve water in the Ogallala aquifer in West Texas. The other project will provide up to \$3.8 million for a project designed to improve agricultural water use in the lower Rio Grande Valley, a region that has limited water resources and an expanding population.

**Water Conservation Implementation Task Force report.** A final major water conservation bill enacted in 2003 was HB 1094 by Duncan. This law created the Water Conservation Implementation Task Force, a group charged with evaluating matters related to conservation throughout the state. In response to the numerous water conservation proposals that had been considered by the Legislature in recent sessions, the task force was directed to research conservation strategies and create two reports: a best management practices guide and a list of legislative recommendations. The task force released drafts of each document for public comment on August 2, 2004, and the comment period closed on August 23. On September 27, the task force unanimously adopted its draft report. The final reports will be delivered to the Legislature by November 1, 2004.

The task force's draft legislative report includes 25 recommendations. Major recommendations include:

- creating a statewide water conservation public-awareness program, comparable to the Don't Mess with Texas anti-litter campaign;

- providing one regional water conservation coordinator for each of the 16 water planning groups to assist communities on conservation activities;
- continuing and expanding funding for the State Brush Control Program (see *Water conservation and brush control*, page 8);
- encouraging retail public water suppliers to develop a water conservation plan designed to reduce average per capita water use to 140 gallons per day.
- creating a standing water conservation advisory council to advise the Legislature and state agencies on conservation issues;
- developing an Internet-based database to track regional water conservation plans;
- establishing performance standards for toilets to ensure water savings in low-flow models; and
- protecting the water rights of landowners who practice conservation.

The task force's final report and recommendations likely will be a focal point for conservation-related water planning in the 2005 legislative session. Although the task force voted 29-0 in favor of the report, there was some disagreement regarding certain proposals. One dissenting minority report, submitted by Ken Kramer of the Lone Star Chapter of the Sierra Club, challenged the recommendation that average per capita daily water use be reduced from the current level of 164 gallons to 140 gallons. Kramer argued that because some cities already have met the 140-gallon-per-day target, the goal to reduce average water use should be lowered to 125 gallons per resident per day. Other proposals could face opposition because their implementation would require additional appropriation in the state budget.

— by **Tedd Holladay**

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