

STATE OF ARIZONA
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DEPT. OF INSURANCE

REPORT OF TARGET MARKET EXAMINATION

OF

AUTO-OWNERS INSURANCE COMPANY

NAIC #18988

AS OF

June 30, 2007

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CHRISTINA URIAS
Director of Insurance

Honorable Christina Urias
Director of Insurance
State of Arizona
2910 North 44th Street
Suite 210, Second Floor
Phoenix, Arizona 85108-7256

Dear Director Urias:

Pursuant to your instructions and in conformity with the provisions of the Insurance Laws and Rules of the State of Arizona, a desk examination has been made of the market conduct affairs of the:

AUTO-OWNERS INSURANCE COMPANY
NAIC #18988

The above examination was conducted by Helene I. Tomme, CPCU, CIE, Market Examinations Supervisor, Examiner-in Charge, and Linda L. Hofman, AIE, FLMI, AIRC, CCP, Senior Market Examiner and Christopher G. Hobert, CIE, FLMI, AIRC, CCP Market Examiner.

The examination covered the period of July 1, 2006 through June 30, 2007.

As a result of that examination, the following Report of Examination is respectfully submitted.

Sincerely yours,

Helene I. Tomme, CPCU, CIE
Market Examinations Supervisor
Market Oversight Division

FOREWORD

This targeted market examination report of Auto-Owners Insurance Company (herein referred to as "Auto-Owners", "AOIC", or the "Company"), was prepared by employees of the Arizona Department of Insurance (Department) as well as independent examiners contracting with the Department. A market examination is conducted for the purpose of auditing certain business practices of insurers licensed to conduct the business of insurance in the state of Arizona. The Examiners conducted the examination of the Company in accordance with Arizona Revised Statutes (A.R.S.) §§ 20-142, 20-156, 20-157, 20-158 and 20-159. The findings in this report, including all work product developed in the production of this report, are the sole property of the Department.

The examination consisted of a review of the following Homeowners (HO) and Commercial (Comm'l) lines of business operations:

1. Complaint Handling
2. Claims Processing

Certain unacceptable or non-complying practices may not have been discovered in the course of this examination. Additionally, findings may not be material to all areas that would serve to assist the Director.

Failure to identify or criticize specific Company practices does not constitute acceptance of those practices by the Department.

SCOPE AND METHODOLOGY

The examination of the Company was conducted in accordance with the standards and procedures established by the National Association of Insurance Commissioners (NAIC) and the Department. The market examination of the Company covered the period of July 1, 2006 through June 30, 2007 for business reviewed. The purpose of the examination was to determine the Company's compliance with Arizona's insurance laws, and whether the Company's operations and practices are consistent with the public interest. This examination was completed by applying tests to each examination standard to determine compliance with the standard. Each

standard applied during the examination is stated in this report and the results are reported beginning on page 8.

In accordance with Department procedures, the Examiners completed a Preliminary Finding ("Finding") form on those policies, claims and complaints not in apparent compliance with Arizona law. The finding forms were submitted for review and comment to the Company representative designated by Company management to be knowledgeable about the files. For each finding the Company was requested to agree, disagree or otherwise justify the Company's noted action.

The Examiners utilized both examinations by test and examination by sample. Examination by test involves review of all records within the population, while examination by sample involves the review of a selected number of records from within the population. Due to the small size of some populations examined, examination by test and by sample were completed without the need to utilize computer software.

File sampling was based on a review of underwriting and claim files that were systematically selected by using Audit Command Language (ACL) software and computer data files provided by the Company. Samples are tested for compliance with standards established by the NAIC and the Department. The tests applied to sample data will result in an exception ratio, which determines whether or not a standard is met. If the exception ratio found in the sample is, generally less than 5%, the standard will be considered as "met." The standard in the areas of procedures and form use will not be met if any exception is identified.

HISTORY OF THE COMPANY

(Provided by the Company)

Auto-Owners Insurance is one of the largest property and casualty insurance companies domiciled in Michigan.

Auto-Owners success can be traced back from its present management to the early leadership of Vern V. Moulton who, in 1916, organized Auto-Owners Insurance Company in Mt. Pleasant, MI. The infant Company had no capital and was housed in one room of a bank building.

Auto-Owners operated in Mt. Pleasant for a little less than a year. In 1917, V.V. Moulton literally picked the Company up, placed it under his arm and in his pocket (the Company consisted of one book of policyholders' names and \$174.25 in assets), and moved Auto-Owners to Lansing, Michigan.

It wasn't long before the Depression began, and Auto-Owners weathered even the lowest point of that era – the bank holidays of February 1933. The Company demonstrated its corporate toughness and financial stability by paying all claims promptly, daily, and IN CASH! The firm was then writing more than \$2.5 million in insurance premiums.

Auto-Owners entered the general casualty insurance field in 1940, having previously written only automobile insurance. During the next five years, the Company found it necessary to acquire three more buildings in the vicinity of its main office to accommodate its continued growth.

Today, Auto-Owners has full-service offices in Lansing, MI; Traverse City, MI; Montgomery, Alabama; Mesa, Arizona; Westminster, Colorado; Lakeland, Florida; Tallahassee, Florida; Duluth, Georgia; West Des Moines, Iowa; Marion, Indiana; Peoria, Illinois; Lexington, Kentucky; White Bear Lake, Minnesota; Columbia, Missouri; Charlotte, North Carolina; Fargo, North Dakota; Lima, Ohio; Columbia, South Carolina; Brentwood, Tennessee; Appleton, Wisconsin; and with claim offices in 72 cities.

The Company wrote business in Michigan exclusively from 1916 until 1935 when it began writing insurance in Indiana and Ohio. In the forties, Auto-Owners extended operations to include Illinois and Minnesota and, during the fifties, Iowa, North and South Dakota, Florida, Missouri, Alabama, Tennessee, and North and South Carolina. The Company began operations in Wisconsin in 1969, Georgia in 1973, Nebraska in 1978, Arizona in 1982, Virginia in 1989, Kentucky in 1994, Kansas in 1996, Utah in 1997, Colorado in 1999, Arkansas in 2005 and Idaho in July 2006.

The current Auto-Owners home office is located in a business and residential complex called Verndale, in Delta Township, west of Lansing. This building was constructed in 1975 and has been expanded three times, increasing its size to 404,616 square feet.

The Lansing corporate office services not only Auto-Owners Insurance Company, but its subsidiary companies: Auto-Owners Life Insurance Company, Home-Owners Insurance Company, Owners Insurance Company, Property-Owners Insurance Company, and Southern-

Owners Insurance Company. The Lansing Branch Underwriting and Lansing Branch Claims offices are also housed in the same complex.

Auto-Owners success evolves from its loyal agents, policyholders and associates. The Companies are represented by more than 5,900 independent agencies, selling personal and commercial property/casualty and life, health and annuity insurance in 25 states. Total associates number more than 3,300.

The Auto-Owners Insurance Group ranks among the largest in the nation, with over 4.2 million personal, commercial and life policies issued and renewed. The Companies also enjoy the highest possible ratings assigned by nationally recognized independent rating authorities.

PROCEDURES REVIEWED WITHOUT EXCEPTION

The Examiners review of the following Company department¹ or function indicates that they appear to be in compliance with Arizona statutes and rules.

Complaint Handling

EXAMINATION REPORT SUMMARY

The examination revealed three (3) compliance issues that resulted in 41 exceptions due to the Company's failure to comply with statutes and rules that govern all insurers operating in Arizona. These issues were found in one (1) of the two (2) sections of Company operations examined. The following is a summary of the Examiners' findings:

Claims Processing

In the area of Claims Processing, three (3) compliance issues are addressed in this report as follows:

- The Company failed to pay appropriate tax, license registration and/or air quality fees on one (1) first party total loss claim, which resulted in an underpayment of \$15.95 including interest.

¹ If a department name is listed there were no exceptions noted during the review.

- The Company failed to complete its investigation within 30 days after notification of the claim. This occurred in 7 HO and 12 Comm'l claim files for a total of 19 claim files.
- The Company failed to file and record documentation in such detail that pertinent events and the dates of such events could be reconstructed. This occurred in 9 HO and 12 Comm'l claim files for a total of 21 claim files.

FACTUAL FINDINGS

RESULTS OF PREVIOUS MARKET EXAMINATIONS

During the past three (3) years, there were two (2) Market Conduct Examinations completed by the states of Missouri and Colorado. There were no significant patterns of non-compliance noted.

CLAIMS PROCESSING

Homeowners (HO):

The Examiners reviewed 34 HO claims closed without payment (no sample files included) from a population of 34; 50 HO paid claims (no sample files included) from a population of 122. This claim review included a total sample size of 84 HO claims files from a total population of 156.

Commercial (Comm'l):

The Examiners reviewed 50 Comm'l claims closed without payment (no sample files included) from a population of 359; 50 Comm'l paid claims (no sample files included) from a population of 645 and 25 Comm'l subrogation claims out of a population of 25. This claim review included a total sample size of 125 Comm'l claims files from a total population of 1,029.

All claim files were reviewed to ensure compliance with Arizona Statutes and Rules.

The Following Claim Standards were met:

| # | STANDARD | Regulatory Authority |
|----|---|---|
| 1 | The initial contact by the company with the claimant is within the required time frame. | A.R.S. § 20-461, A.A.C. R20-6-801 |
| 3 | The company claim forms are appropriate for the type of product and comply with statutes, rules and regulations. | A.R.S. §§ 20-461, 20-466.03, 20-2106, A.A.C. R20-6-801 |
| 6 | The company uses reservation of rights and excess of loss letters, when appropriate. | A.R.S. § 20-461, A.A.C. R20-6-801 |
| 7 | Deductible reimbursement to insureds upon subrogation recovery is made in a timely and accurate manner. | A.R.S. §§ 20-461, 20-462, A.A.C. R20-6-801 |
| 8 | The company responds to claim correspondence in a timely manner. | A.R.S. § 20-461, 20-462, A.A.C. R20-6-801 |
| 9 | Denied and Closed Without Payment claims are handled in accordance with policy provisions and state law. | A.R.S. §§ 20-461, 20-462, 20-463, 20-466, 20-2110, A.A.C. R20-6-801 |
| 10 | No insurer shall fail to fully disclose to first party claimants all pertinent benefits, coverages or other provisions of an insurance policy or insurance contract under which a claim is presented. | A.A.C. R20-6-801 |
| 11 | Adjusters used in the settlement of claims are properly licensed | A.R.S. §§ 20-321 through 20-321.02 |

The following Claim Standard passed with Comment:

| # | STANDARD | Regulatory Authority |
|---|--|--|
| 5 | Claims are properly handled in accordance with policy provisions and applicable statutes, rules and regulations. | A.R.S. §§ 20-268, 20-461, 20-462, A.A.C. R20-6-801 |

The following Claim Standards failed:

| # | STANDARD | Regulatory Authority |
|---|---|---|
| 2 | Timely investigations are conducted. | A.R.S. § 20-461, A.A.C. R20-6-801 |
| 4 | Claim files are adequately documented in order to be able to reconstruct the claim. | A.R.S. §§ 20-461, 20-463, 20-466.03, A.A.C. R20-6-801 |

Claims Processing Standard #2 – failed:

Preliminary Finding-002 – Timely Investigation: The Examiners identified seven (7) HO and 12 Comm'l claims for a total of 19 claims, in which the Company failed to complete its investigation within 30 days after notification of claim. This action is an apparent violation of A.R.S. § -20 461 and A.A.C. R20-6-801.

HOMEOWNERS' CLAIMS

Failed to complete a timely investigation

A.R.S. § 20-461, A.A.C. R20-6-801

| Population | Sample | # of Exceptions | % to Sample |
|------------|--------|-----------------|-------------|
| 156 | 84 | 7 | 8% |

An 8% error ratio does not meet the Standard; therefore, a recommendation is warranted.

COMMERCIAL CLAIMS
 Failed to complete a timely investigation
 A.R.S. § 20-461, A.A.C. R20-6-801

| Population | Sample | # of Exceptions | % to Sample |
|------------|--------|-----------------|-------------|
| 1,029 | 125 | 12 | 10% |

A 10% error ratio does not meet the Standard; therefore, a recommendation is warranted.

Recommendation #1

Within 90 days of the filed date of this report provide the Department with documentation that the Company's claims procedures regarding complete and timely investigation has been reviewed with all claim adjusters handling Arizona claims and re-training has been completed where necessary or warranted

Subsequent Events: During the course of the Phase I Examination, the Company disagreed with the Examiner's findings on 16 claim files and agreed with the remaining 4 claim files for a total of 20 files regarding timely investigation. However, upon being supplied with further documentation, the Examiners withdrew one (1) commercial claim file and revised the total number of exceptions to 19 claim files. The Examiners feel the finding is appropriate and should stand as written.

Claims Processing Standard #4 – failed:

Preliminary Finding-001 – Missing File and Record Documentation: The Examiners identified 9 HO and 12 Comm'l claims for a total of 22 claims, in which the Company failed to adequately document the claims in such detail that pertinent events and the dates of such events could be reconstructed. This action is an apparent violation of A.R.S. §§ 20-461, 20-463, 20-466.03 and A.A.C. R20-6-801.

HOMEOWNERS' CLAIMS
 Failed to adequately document
 A.R.S. §§ 20-461, 20-463, 20-466.03, A.A.C. R20-6-801

| Population | Sample | # of Exceptions | % to Sample |
|------------|--------|-----------------|-------------|
| 156 | 84 | 9 | 11% |

A 12% error ratio does not meet the Standard; therefore, a recommendation is warranted.

COMMERCIAL CLAIMS

Failed to adequately document

A.R.S. §§ 20-461, 20-463, 20-466.03, A.A.C. R20-6-801

| Population | Sample | # of Exceptions | % to Sample |
|------------|--------|-----------------|-------------|
| 1,029 | 125 | 12 | 10% |

A 10% error ratio does not meet the Standard; therefore, a recommendation is warranted.

Recommendation #2

Within 90 days of the filed date of this report provide the Department with documentation that the Company's claims procedures have been reviewed with all claims adjusters handling Arizona claims regarding adequately documenting claim files in such detail that pertinent events and dates of such events can be reconstructed. In addition, provide documentation that re-training of claim adjusters handling Arizona claims and re-training has been completed where necessary or warranted.

Subsequent Events: During the course of the Phase I Examination, the Company disagreed with the Examiner's findings on 10 claim files and agreed with the remaining 12 claim files regarding adequate documentation. However, upon being supplied with further documentation, the Examiners withdrew one (1) homeowners' claim file and revised the total number of exceptions to 21 claim files. The Examiners feel the finding is appropriate and should stand as written

Claims Processing Standard #5 – passed with comment:

Preliminary Finding-003 – Commercial Automobile total losses:

The Examiners identified one (1) first total loss settlement, in which the Company failed to pay the appropriate tax. This action is an apparent violation of A. R. S. §§ 20-268, 20-461(A)(6), 20-462 and AAC R20-6-801(H)(1)(b).

COMMERCIAL CLAIMS

Failed to pay appropriate taxes on a total loss

A.R.S. §§ 20-268, 20-461(A)(6), 20-462(A) and A.A.C. R20-6-801 (H)(1)(b)

| Population | Sample | # of Exceptions | % to Sample |
|------------|--------|-----------------|-------------|
| 645 | 50 | 1 | 2% |

A 2% error ratio meets the standards; therefore, no recommendation is warranted

Subsequent Events: During the course of the Phase I Examination, the Company agreed with the Examiner's finding of \$13.75 plus \$2.20 in interest; however, the Company made a restitution payment to the first party insured in the amount of \$13.75 plus \$2.75 in interest for a total of \$16.50. Copies of the letter of explanation and payment were sent to the Department prior to completion of the Examination.

SUMMARY OF FAILED STANDARDS

| EXCEPTIONS | Rec. No. | Page No. |
|--|-----------------|-----------------|
| CLAIMS PROCESSING | | |
| <u>Standard #2</u> Timely investigations are conducted. | 1 | 14 |
| <u>Standard #4</u> Claim files are adequately documented in order to reconstruct the claim. | 2 | 15 |

SUMMARY OF PROPERTY AND CASUALTY STANDARDS

Complaint Handling

| # | STANDARD | PAGE | PASS | FAIL |
|---|---|------|------|------|
| 1 | The company takes adequate steps to finalize and dispose of the complaints in accordance with applicable statutes, rules, regulations and contract language. (A.R.S. § 20-461 and A.A.C. R20-6-801) | 8 | X | |
| 2 | The time frame within which the company responds to complaints is in accordance with applicable statutes, rules and regulations. (A.R.S. § 20-461 and A.A.C. R20-6-801) | 8 | X | |

Claims Processing

| # | STANDARD | PAGE | PASS | FAIL |
|---|---|------|------|------|
| 1 | The initial contact by the company with the claimant is within the required time frame. (A.R.S. § 20-461 and A.A.C. R20-6-801) | 12 | X | |
| 2 | Timely investigations are conducted. (A.R.S. § 20-461, and A.A.C. R20-6-801) | 13 | | X |
| 3 | The company claim forms are appropriate for the type of product and comply with statutes, rules and regulations. (A.R.S. §§ 20-461, 20-466.03, 20-2106, and A.A.C. R20-6-801) | 12 | X | |
| 4 | Claim files are adequately documented in order to be able to reconstruct the claim. (A.R.S. §§ 20-461, 20-463, 20-466.03 and A.A.C. R20-6-801) | 13 | | X |
| 5 | Claims are properly handled in accordance with policy provisions and applicable statutes, rules and regulations. (A.R.S. §§ 20-268, 20-461, 20-462 and A.A.C. R20-6-801) | 13 | X | |
| 6 | The company uses reservation of rights and excess of loss letters, when appropriate. (A.R.S. § 20-461 and A.A.C. R20-6-801) | 12 | X | |
| 7 | Deductible reimbursement to insureds upon subrogation recovery is made in a timely and accurate manner. (A.R.S. §§ 20-461, 20-462 and A.A.C. R20-6-801) | 12 | X | |

| # | STANDARD | PAGE | PASS | FAIL |
|----|--|------|------|------|
| 8 | The company responds to claim correspondence in a timely manner. (A.R.S. § 20-461, 20-462 and A.A.C. R20-6-801) | 12 | X | |
| 9 | Denied and closed without payment claims are handled in accordance with policy provisions and state law. (A.R.S. §§ 20-461, 20-462, 20-463, 20-466, 20-2110 and A.A.C. R20-6-801) | 12 | X | |
| 10 | No insurer shall fail to fully disclose to first party Insureds all pertinent benefits, coverages, or other provisions of an insurance policy or insurance contract under which a claim is presented. (A.A.C. R20-6-801) | 12 | X | |
| 11 | Adjusters used in the settlement of claims are properly licensed (A.R.S. §§ 20-321 through 20-321.02) | 12 | X | |