

Q&A on Homeowners' Insurance Regulation in Texas

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The Texas Department of Insurance is undergoing Sunset Review in 2008. This Q&A is based on the Center's response to a series of questions on TDI from the Texas Sunset Commission.

Does a focus on affordability in insurance regulation help consumers and promote competition?

Historically, the primary basis for rate regulation for personal lines of insurance, such as auto and homeowners' insurance, was to ensure company solvency. Today, the focus in Texas and elsewhere seems to be on the concept of affordability, which is both relative and subjective: What is affordable for one consumer may not be affordable for another. There can be no actuarially-sound rate that is affordable for everyone.

The pursuit of affordability in Texas has led to a focus on preventing excessive rates. To this end, the Insurance Code prohibits rates from being excessive. However, this statutory emphasis on excessive rates conflicts with other statutory provisions that 1) prohibit "inadequate" rates, 2) "promote the availability of insurance," and 3) "promote price competition among insurers."

The overemphasis on low rates has been found to be "wasteful, produce higher industry costs, delay innovation, reduce competition, slow the introduction of new products to the market, and build operational inefficiencies into businesses that are regulated." That is, rate regulation focused on affordability disrupts consumer choice and results in inefficient and anti-competitive pricing. Likewise, the regulation of homeowners' insurance in Texas produces poor results for consumers—such as swings in price and availability.

Ultimately, a regulatory stance focused on affordability reduces investment and hinders competition in the Texas insurance marketplace. Insurers assess risk years into the future, but today they can't even predict what their income will be next year.

If what the Texas Department of Insurance (TDI) calls "legacy" cases, i.e., State Farm and Allstate, are included with other companies subject to what has come to be known as "file and haggle," over 60 percent of the market is adversely affected by the over-emphasis on excessive rates. None of the insurers involved can properly assess costs based on risk versus income premiums in future years. This has a chilling effect on Texas' ability to attract capital and new insurers; over time, the absence of both will reduce competition and keep rates artificially inflated.

Additionally, the overemphasis on excessive rates can divert attention and resources away from ensuring the solvency of companies. Much like the Texas Windstorm Insurance Association (TWIA), companies forced to offer below-market rates may be unable to cover claims against their policies, leaving many homeowners at risk of having no insurance at all. Focusing on affordability—as opposed to solvency—puts insurers and taxpayers at risk, leaving insurers unprotected against insolvency, reducing consumer choice, and thwarting competition—with none of the statutory mandates achieved.

One of TDI's funded objectives is to "Encourage financial health of insurance indus-

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try through monitoring and regulation of insurance solvency.” In 2006, the insolvency of Texas Select Lloyds Insurance Company became the first major insolvency of a Texas insurer in many years. Within about a month, thousands of policyholders were forced to find another insurer. The monitoring of insurer solvency requires substantial resources, and the focus on affordability of rates uses human and financial resources that could be better used to focus on solvency.

If insurance regulation shouldn't focus on affordability, what should it focus on?

No one—whether a single market participant or a regulator—can efficiently set prices outside of the market process. In the case of regulators—who cannot control the underlying costs and risks associated with homeowners' insurance—subjective determinations of affordability make it impossible for them to promote fairness and solvency. So when costs rise, regulators are forced to turn to wealth redistribution, through subsidized rates for high-risk consumers.

While TDI could make internal changes that would vastly improve its regulation of the industry, its inability to balance its many mandates is ultimately because the statutory mandates inherently conflict with each other. The subjective nature of balancing these competing interests in a regulatory setting guarantees poor results.

Section 2251.051, Insurance Code, states that, “A rate is excessive if the rate is likely to produce a long-term profit that is unreasonably high in relation to the insurance coverage provided.” The subsequent section says that, when setting rates, an insurer shall consider “a reasonable margin for profit.” There are two reasonable interpretations of this statutory mandate. Regulators could defer to competition to enforce price discipline on insurers and, thus, on their profit margins; or they could decide to determine themselves what a reasonable profit margin is. It seems that for the majority of the market in Texas today, the latter approach is the one taken.

The result is a battle among actuaries. While the arguments among insurance company actuaries and TDI actuaries include questions about loss experience, haz-

ards, operating expenses, etc., the question often seems to come down to whether an insurer is profiting too much from the rates it is charging.

This is when the discussion moves from being a question of actuarial soundness to a question of capital. Insurers have a responsibility to shareholders, policyholders, and taxpayers to earn returns that allow companies to attract the capital needed to stay in business, maintain profitability, and pay off future claims. Actuaries—whether at TDI or an insurer—are incapable of determining what rate of return is acceptable to capital markets. And when they make a mistake and capital markets judge profit levels to be too low, solvency becomes an issue.

The problem with a statute that allows regulators to set profit margins for insurers is highlighted when TDI disapproves rates of some insurers, even though the rates are lower than those approved for other insurers. This does nothing but penalize efficiency. An insurer may become more efficient in order to cut costs, attract more investment capital, and maintain solvency. Yet a focus on profit margins inappropriately turns these efficiency gains into an actuarial matter, greatly reducing an insurer's incentives to become more efficient and cut costs.

Texas has had remarkable success in recent years in other markets, notably electricity and telecommunications, when it comes to removing the ability to place “price caps” on rates. Texas is a national leader in this area, as both the telecommunications and electricity markets in Texas are among the most competitive in the world.

Particularly applicable to the insurance debate is Texas' move toward an energy-only electricity market. In Texas, power plant construction is no longer determined by the Public Utility Commission's determination of need and how much a utility should profit from a new plant. Instead, investors are allowed to earn what profits they may from a largely deregulated market. Because of this, Texas has attracted billions of dollars of capital to Texas in the form of new power plants and, as a result, has experienced an abundant supply of energy during the transition to deregulation, unlike many states that have suffered significant power shortages during the same period.

The same success would result from a similar approach in the insurance market, moving away from affordability toward solvency and fairness, i.e., ensuring that companies can pay their claims and base their premiums on risk. Such a system would encourage investment and innovation, as it has in other competitive marketplaces in Texas. More insurance carriers would enter and invest in the Texas market, increasing insurance availability to consumers across the state. Aside from remedying the problem of inadequate rates, this approach to the insurance marketplace would allow for a reduction in TDI's spending on licensing and on regulating rates and forms, as well as the dollars spent on administrative and technical support.

TDI's statutory mandate in Section 2251.001(1) should be changed to read: "promote the public welfare by regulating insurance rates to prohibit [~~excessive~~] inadequate[;] or unfairly discriminatory rates." Other provisions in Chapter 2251 should be changed to comport with this. Absent a statutory change, TDI should adopt the reasonable interpretation of Sections 2251.051 and 2251.052 that allows competition and capital markets to discipline prices and profits.

These changes would shift TDI's regulatory focus to fairness and solvency. Such a focus, with the attendant shift from rate regulation to market-determined rates, will give Texas policyholders the benefits that insurance markets in several other states—as well as other non-insurance markets in Texas—are already reaping (see below).

What's wrong with encouraging "fair" competition?

TDI's first funded objective is to "Encourage fair competition in the insurance industry by reducing impediments to competition and improving insurance availability." However, a focus on "fair" competition actually creates impediments to competition and availability—TDI becomes a third party to what should properly be a two-party marketplace.

TDI is required by statute to "promote price competition," not to encourage fair competition. While fairness is certainly contemplated in the statute, it is focused not on competition, but on the prohibition of "unfairly discriminatory rates."

A focus on fair competition undermines price competition—as well as the mandates to focus on availability of insurance and solvency of rates. This undermines TDI's ability to carry out its functions properly. Companies not allowed to price for risk will be unwilling and unable to be fully competitive on prices—at least without risking insolvency.

A better application of TDI's statutory mandates would change this funded objective to: "promote price competition and the availability of insurance by reducing regulatory impediments to competition in the insurance industry." Allowing consumers and capital markets to determine the appropriateness of a rate is the best approach. And this is a self-correcting mechanism, where companies will adjust their rates to meet market conditions.

Are consumers helped or hurt by the regulation of forms?

Another funded objective of TDI is to "Encourage fair competition in the insurance industry by reducing unfair and illegal practices."

It could be argued that TDI's statutory mandate to "prohibit price-fixing agreements and other anticompetitive behavior by insurers" is a mandate to encourage fair competition. However, the focus on fair competition is counterproductive to policing anticompetitive behaviors. As noted above, the focus on fair competition has itself restricted price competition. The restriction of price competition, including the inability of insurers to price risk adequately, also makes it much more likely that rates will be unfairly discriminatory, when that term is properly understood to mean that policyholders have to pay market rates unrelated to their insured risks.

One application of this objective—the regulation of forms—has inflicted significant harm on consumers at times during the last ten years. The statutory provision—and its implementation by TDI—to regulate forms in Chapter 2301, is counterproductive to almost all of the other purposes outlined in Chapter 2251 and to the purpose in Chapter 2301 itself to promote the availability of insurance.

Following a 1999 lawsuit that resulted in a 2001 finding that TDI's standard form required insurers to cover mold claims, mold claims grew from 1,050 in the first quarter of 2000 to 14,706 in the fourth quarter of 2001. The average cost of mold claims per policyholder per year increased from \$24.32 in 1999 to \$300.50 at the end of 2001, having peaked in the third quarter at \$444.35. From 2000 to 2003, companies writing homeowners' policies in the state shrank from 137 to 101. Consequently, premiums rapidly increased, though not nearly as fast as claims. In 2001-02, premiums increased by over 40 percent. All Texas homeowners had to pay higher rates, and many were forced into the residual market because of a lack of availability.

All of this was due to three things: 1) incorrect judicial interpretation of the standard homeowners' form, 2) a feeding frenzy of lawsuit abuse following the first lawsuit, and 3) TDI's belated implementation of a 1997 provision allowing companies to use forms other than the standard state form.

Conventional wisdom has the "mold crisis" coming to an end after the Legislature rewrote insurance laws in 2003, but the facts show it was the change in forms allowed by TDI in 2002 that made the difference.

Mold claims plummeted in 2003, beginning well before the effective date of SB 7, and for the first time in four years, premiums collected exceeded losses and costs, if only slightly. Premiums for individual policies also began to stabilize. TDI estimated that the 2002 changes in mandated coverage saved consumers an average of 13.5 percent on a theoretical policy with a premium of \$1,000.

An August 2002 article in *The Dallas Morning News* featured the headline, "Home insurance up, but not much. Rates have stabilized since May, stay above state standard in area." TDI also reported to the Texas Legislature in March 2003 that "[r]ates in 2003 appear to be leveling off. Barring any further destabilization of the market, the Department anticipates this trend to continue on a broad scale, if not improve." The department acknowledged that, without the deregulation of forms, rates could have increased at least 20 percent more than they did. Though it is clear that the cause of the mold

crisis lay in the abuse of the legal system, the damage done by this would have been lessened or perhaps even largely avoided if TDI had implemented the 1997 provision in a timely manner.

Regulation of policy forms in Texas is still a problem. After Hurricane Rita in 2005, TDI sued Allstate, saying its form should cover alternative living expenses in cases where there is no damage to the home, even though the form doesn't actually say that. However, the courts rejected the reasoning by TDI in deference to the plain language of the forms.

Regulation of forms by TDI should be eliminated. While the regulation of forms may be intended to reduce "unjust, unfair, inequitable, misleading, or deceptive" practices, it harms the very consumers it is intended to help. Fraudulent and deceptive practices are illegal in Texas and can be dealt with through a number of channels. Legal matters can be handled by the judiciary, where the proper parties in a dispute over a private contract—the insurers and policyholders—can resolve such matters. The investigative and enforcement aspects of this could be handled by law enforcement officials, including prosecutors and investigators, in cases of illegal activity.

Do consumers really need to be "protected" by TDI and OPIC?

In today's consumer-friendly society, the need for consumer protection by TDI and the Office of Public Insurance Counsel (OPIC) is limited. The availability of information greatly enhances the ability of the consumer to shop wisely, providing both consumer education and protection. In addition, general consumer protection laws and the civil and criminal justice systems are adequate to meet the needs of consumers.

Ultimately, competition is the best consumer protection measure available. Competition punishes companies that set their prices too high or engage in unfriendly (and even illegal) practices. How? In a competitive market, consumers can simply switch to another producer/provider.

Over the last couple of years, however, the large market share of certain "incumbent" providers in both the

homeowners' insurance and electricity markets has led to calls for increased consumer protection. The lack of consumers switching away from these providers to new entrants—known as consumer stickiness—has been held up as a sign of market failure and lack of competition in these markets, and used to justify calls for new “consumer protection” measures. However, the truth is that consumer stickiness is an integral part of the market process, based on individual preferences.

The idea that consumer stickiness is a sign of reduced competition calling for enhanced consumer protections stems from the theoretical construct by economists known as “perfect competition,” something completely unlike real-world competition. As such, judging actual markets based on theoretical models discounts the importance of personal preference.

By accounting for individual preference, or consumer choice, one can then understand that a genuine marketplace is one where “business organizations of various sizes continually strive to discover which products and services consumers desire, and at what prices, and continually strive to supply those products and services at a profit to themselves and at the lowest cost.” Products and companies succeed because they are the most efficient at meeting the preferences of the individual consumer. Consumer stickiness is bad and markets inefficient only in the eyes of the critics who have substituted their own preferences for those of consumers. This is certainly the case in Texas today, with calls for increased consumer protection in the electricity and homeowners' insurance markets.

If competition were working in these markets, critics contend, more people would have left the larger providers and chosen providers who offered lower prices. They say the existence of consumers sticking with higher prices is proof that consumer choice is not readily available; thus, consumers need protection from the larger companies who are profiting at their expense. Of course, no standard is offered for how much business the firms should lose before competition is considered to be optimal.

Although the economic model of perfect competition suggests the number of consumers switching providers should increase as the costs of doing so are lessened,

research examining online consumer stickiness shows this is not the case. Even though the internet allows consumers to search and frequently switch to alternative providers at minimal cost, Brynjolfsson and Smith found “that while there is lower friction in many dimensions of Internet competition, branding, awareness, and trust” mean that consumers are still willing to pay higher prices to retailers with whom they have previously dealt.

Kim and Kim summarize other studies on this subject: “Another study (Johnson et al. 2004) showed that 70 percent of the CD and book shoppers are locked-in to just one site and consumers tend to search fewer sites as they become more experienced with online shopping. Consumers may be locked in to the initial choice mainly because switching behavior is not only economic in nature (Morgan and Hunt 1994) but also can be psychological and emotional (Sharma and Patterson 2000).”

In other words, a high level of consumer stickiness could well indicate the presence of a very efficient market in which consumers can more readily confirm the validity of the choices they have made—choices based not only on cost but on multiple factors that lead to the satisfaction of individual consumer preference.

Although it is true that the collection of rate and policy information on TDI's (and OPIC's) website is a very convenient place for consumers to get information on homeowners' policies, the Sunset Review process should closely examine the consumer protection, enforcement, and education functions of TDI and OPIC to determine which are still relevant and necessary in today's modern marketplace.

What lessons can be learned from the regulation of other industries in Texas and applied to insurance regulation?

Texas leads the United States, if not the world, in the deregulation of the telecommunications and electricity markets. Both markets are world-class examples of how markets—not governments—foster competition and innovation, promote consumer welfare, and regulate industry practices.

However, in the past, heavy emphasis on affordability led to rate-of-return regulation in both markets. For decades, the only consumer choice in the electricity market was whether a customer wanted to turn on the lights; the telecom market wasn't much better, offering consumers such choices as a party line versus a single line, a black phone versus a white phone. There was no choice because there was no opportunity to profit; thus, there was no competition and no incentive to innovate and risk capital.

Unlike the insurance market, insolvency was generally not a problem. But this was because costs were predictable and controllable, and rate-of-return regulation could almost guarantee a certain level of profit. However, even in such a stable market, the focus on affordability required heavy subsidies, where certain classes of customers subsidized other classes. Thus, prices were not based on market demand or even on costs but rather on policymakers' determinations of what price was suitable for customers.

In the telecom market, the unsustainability of the emphasis on affordability became apparent beginning in the 1960s. Over time, affordability has almost—though not quite—disappeared as a factor in most sectors of the marketplace. What has happened as a result? Prices for products have plummeted, while quality and features have increased rapidly. Competition is strong, and consumers are offered choices unthinkable only two decades ago.

A similar development took place in the electricity market. However, in this case, policymakers made a conscious decision that affordability—along with reliability—could better be achieved through the market than through regulation. The resulting deregulation of the Texas electricity market has resulted in the most competitive electric market in the U.S., if not the world. Innovation is bringing consumers a vast array in products and prices. Texas has an extremely reliable supply. And while prices have not decreased as policymakers had hoped, the deregulation allowed Texas to weather the shocks in natural gas prices much better than would have been possible under the previous system. With natural gas prices finally steady, the benefits of electric deregulation are now becoming readily apparent.

Empirical evidence shows free market competition is the most cost-effective and consumer-friendly method to reform the insurance industry. Competitive markets work in other sectors in Texas; they will work in the Texas insurance market, as well.

What can Texas learn from insurance regulation in other states?

Approaching insurance markets from a competitive perspective is not limited to economic theories and models. Outside of Texas, competition yields benefits for insurance markets.

For example, Illinois has followed a competition-based insurance market for personal lines, such as auto and homeowners' insurance, since 1971. Due to the size of the state and length of time that it has operated without price controls, Illinois represents an excellent case to examine the benefits or problems with this approach.

A study comparing Illinois' auto insurance market to comparable states found Illinois to have "less variable loss ratios and rate levels, lower consumer prices, the highest number of insurance carriers in the nation, and a low number of uninsured drivers." The automobile residual market in Illinois also routinely ranks well below the national average. The Herfindahl Index (HHI) for homeowner's insurance in Illinois has remained stable and low from 2000 through 2004. Illinois homeowners face weather similar in severity and variety to Texas yet have been able to sustain a healthy market without regulation. All signs from the Illinois insurance industry point to a healthy, stable, and thriving marketplace that benefits consumers.

Another example comes from the once-active regulatory state of South Carolina. An auto insurance availability crisis erupted after years of rate suppression and regulation, whereby insurance companies chose to exit the market rather than deal with the state's heavy-handed oversight. The residual market reached 40 percent of insured drivers, while the pool of sellers shrunk. In 1997, the Legislature passed sweeping reforms that deregulated auto insurance and increased competition. South Carolina's reliance on competition to help the auto insurance industry resulted in the doubling of the

number of insurers writing policies, a steadying of rates, and a vastly reduced residual market.

The District of Columbia experienced a similar auto insurance crisis. Following free market reforms passed in 1996, D.C. also had insurance providers return to the market, while premiums declined, and the residual market decreased by 80 percent.

Positive results are being realized in insurance markets embracing competition. Texas policyholders deserve the same benefits, which will spring from an insurance marketplace unfettered by government regulation.

Can the federal government provide Texas with any ideas to improve insurance regulation?

While Texans are often hesitant to follow the federal government's lead, a couple of ideas being discussed in Washington D.C. are worth considering.

In 2006, Rep. John Shadegg (R-AZ) and Sen. Jim DeMint (R-SC) proposed the Health Care Choice Act (H.R. 2355 and S. 1015). Through this legislation, individuals in one state would be free to buy health insurance policies that are licensed in other states.

The Texas Legislature could adopt legislation that is based on this proposal by allowing Texans to purchase homeowners' insurance from any carrier so long as it is licensed in another state. As under the Health Care Choice Act, "states where health insurers are licensed to sell their plans [would] retain the primary authority to regulate the health insurance product." Texas consumers that purchase plans from out-of-state providers would be afforded protection as prescribed by the licensing state.

As long as these companies are licensed in their respective states of domicile and, thus, regulated by that state's insurance department, TDI would not be burdened by having to regulate these insurers. Texas would, however, reap the competitive benefits of having more insurance

companies operating in the state. Allowing non-Texas insurers to write policies in Texas increases insurance availability and insurance industry competition. The rise in internet availability and proficiency allows consumers in search of insurance easy access to rate shopping across the country. Forcing competition beyond local and state markets will increase consumer choices, while decreasing consumer prices and many of the expenses that come with licensing and regulating at the state level. Finally, the benefits of selling policies in a new state without having to adapt to a new regulatory regime will entice companies to participate.

An alternative to state-fostered competition in the homeowners' insurance market is a concept proposed in the National Insurance Act introduced in 2006 and again in 2007 by Senators John Sununu (R-NH) and Tim Johnson (D-SD). Under this proposed bill, insurance companies operating under multiple state jurisdictions could choose to be regulated at the national level through an "Optional Federal Charter." By bringing uniformity to life and property/casualty insurance, the bill proposed to reduce costs and improve delivery of insurance products. The concept is loosely based on the dual-charter in the banking industry.

Under the optional federal charter, insurance companies will be able to choose federal or state regulation. A federally-licensed insurance carrier could sell insurance in any state, while a state-licensed insurance carrier could sell insurance within its state of licensing. State-licensed insurers would be free to convert to a national charter, and federally-licensed insurers would also be able to convert to a state charter.

The benefits of a unified market and consistent regulatory standards have led to support for the National Insurance Act from a long list of insurance industry organizations. However, concerns that it will open the door to too much federal oversight and create opportunities for excessive federal intervention have led other insurance organizations to oppose the bill. ★

ENDNOTES

¹ Pociask, Stephen B., Joseph P. Fuhr, and Larry F. Darby (2007) "Insurance Regulation: Market or Government Failure?," American Consumer Institute: 8.

² See TDI Self Evaluation Report, <http://www.tdi.state.tx.us/reports/sunset/documents/5tdiserllfinal.pdf>.

About the Authors

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