



PolicyPerspective

The Texas Homeowners' Insurance Market Today

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Recommendations

- Shift the focus of homeowners' insurance rate regulation to guarding against rates that are inadequate or discriminatory.
- Make the homeowners' insurance system a true file-and-use system.
- Implement a true file-and-use system for regulating policy forms.
- Limit the supplementary information insurers may be required to submit to TDI in a rate filing.

"Many people want the government to protect the consumer. A much more urgent problem is to protect the consumer from the government." –Milton Friedman

Unprecedented product variety, choices in sellers, and consumer information have transformed the modern marketplace. Consumers are empowered to shop wisely and are protected from fraud through education and choice. Consumer advocates, media scrutiny, government complaint resolution, and the civil and criminal justice systems are widely available to help consumers right wrongs.

This good news of today's marketplace often gets lost in the political process. Too often when challenges arise for consumers, the first answer seems to be traditional "consumer protection" laws that dictate market behavior, reduce market efficiencies, and curb consumer choice—all in the false hope of helping consumers. Ultimately, these laws hurt consumers more than they help.

Competition is the best consumer-protection measure available, as it punishes companies that set 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 past couple of years, the lack of consumers switching away from certain insurers with large market shares has been held up as a sign of the lack of competition in the Texas homeowners' insurance market. Similar arguments have colored the debate in the electricity market.

In both industries, these arguments have been used to justify significant and costly interventions in the marketplace in the name of consumer protection.

While the interventions in the electricity market never materialized, there have been long-standing restrictions on the Texas homeowners' insurance market. The prior approval system put into place temporarily in 2003 has led to disputes between regulators and companies over rates, some of which remain ongoing.

Until very recently, over 40 percent of the market was subject to rate disputes at any given time since 2004. Additionally, the Texas Department of Insurance's (TDI) internal process for prioritizing rate filing reviews guarantees that rates affecting the majority of the homeowners market—84 percent—will be reviewed. The result of this continued high level of regulatory intervention has been a lack of capital commitment to the Texas homeowners' market.

The Texas Sunset Advisory Commission's Staff Report on TDI highlights the problem:

- In 2003, the Legislature established a system of rate regulation for homeowners' insurance that incorporated both pre-market and post-market regulatory tools.
- TDI uses statutory pre-market regulatory tools without defined practices, making aspects of rate regulation unpredictable.
- The processes for placing insurers under prior approval and releasing insurers

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from prior approval are not defined, creating uncertainty in the system.

- The Legislature cannot judge the success of the shift to file-and-use rate regulation because the system has not been fully implemented.

Perhaps this is most clearly seen from the following Staff Report finding: “Fifty-two new companies have had policy forms approved and approximately 29 companies have begun writing insurance. In 2006, these new companies combined to comprise 3.7 percent of the total homeowners market.”

While the reforms of 2003 have brought new entrants, only about half of the companies that have filed forms have offered rates through them. And of those that entered the market, they occupy only 3.7 percent of the market.

A probable explanation for this is that potential or actual new entrants are still hesitant to commit capital to Texas, given the lack of full implementation of the file-and-use system they were promised.

Despite the lack of full implementation of file-and-use, there is no doubt that market concentration has dropped significantly since the beginning of reforms in 2002 (when policy-form regulation was relaxed). A standard measure of market concentration is the Herfindahl-Hirshman Index (Herfindahl Index). The Herfindahl Index is computed by summing the squared market shares (in percentage terms) of all business firms competing in a market for some defined product or service. The U.S. Department of Justice (DOJ) uses the Herfindahl Index to evaluate the competitive effects of mergers and acquisitions in a given industry or market. According to DOJ standards, values in excess of 1800 suggest an industry is highly concentrated; values between 1000 and 1800 show moderate concentration; and markets with values below 1000 are deemed unconcentrated.

The history of the Herfindahl Index for the Texas homeowners' insurance market shows two things. First, the Texas market is at the low end of the moderately concentrated

range; competition is not hindered here in any meaningful way. Second, the trend clearly shows that reduced regulation is associated with less market concentration and, thus, more competition. From 1998 to 2005, Texas moved from a restrictive flex-band approach* with strict policy forms regulations to a file-and-use approach with less restrictive policy forms regulation. The first significant decrease in market concentration during that time occurred only after policy-form regulation was relaxed.

Year	Herfindahl Index	Regulatory Situation/Events
1998	1662	Heavy regulation: flexible-band rates and form regulation in place
1999	1661	Lawsuit filed claiming standard form covers mold damage
2000	1636	TDI fails to implement 1997 forms changes; mold crisis underway
2001	1611	TDI fails to implement 1997 forms changes; jury awards \$32 million in mold lawsuit; mold crisis increasing
2002	1458	Form regulation relaxed: mold crisis peaks and begins to decline
2003	1388	Flex-band replaced with prior approval; mold crises ends
2005	1258	File-and-use in operation

Texas consumers have clearly benefitted from the reduced concentration (i.e., increased competition) and reduced prices brought about by the relaxing of regulations since 2002. This makes it all the more apparent that consumers are the ones who would be most harmed if the file-and-use system is not completely implemented.

There are numerous ways consumers benefit from increased competition—it is not as if regulators are leaving consumers to the wolves when they withdraw from the market. Here are just a few examples of consumer-oriented practices in a competitive marketplace:

* In addition to the restrictive flex-band regulation, Texas also had what was known as the Lloyd's exemption until 2003. This allowed companies organized as a Lloyd's firm to offer rates outside of the flex-band system. As the rates set under the flex-band system became more and more unrealistic and mold claims continued to rise, more companies chose to offer rates under the Lloyd's exemption. However, it must be recognized that the Lloyd's exception was indeed that: the exception not the rule. Companies were not willing to commit long-term capital to the Texas market based on an exception to the rule, particularly in light of the heavy regulation of forms. At the time, Texas was the only major state that didn't allow some type of national form to be used.

- Businesses seek to maximize consumer satisfaction (high quality, low prices, etc.) in order to maximize profits and avoid losing customers.
- Intermediaries, including retailers, credit card companies, etc., work on consumers' behalf with producers and other participants in the market.
- Firms seek to build name brands by providing consumers high quality, low price, etc.
- Trade associations provide oversight of members in an effort to maintain the favorable opinions of consumers.
- Private organizations, such as Consumers Union and Underwriters Laboratory, provide independent product information to consumers.
- The internet provides a vast array of resources for consumers to share information on products and merchants.
- The civil justice system is available as a remedy for consumers who are harmed.

Consumer-protection laws, however, generally stand in stark contrast to the consumer-friendly workings of today's competitive insurance market, where the voluntary nature of markets forces attention to the needs and desires of consumers. They put the focus on the regulated industries, rather than on the consumer. Rate regulation, for instance, focuses almost exclusively on companies' profit levels. Measures to make competition "fair" focus on the impact of competitive activity on competitors. In neither case are consumers the focus of the regulators.

The result is that consumer-protection measures generally seek to replace consumer preferences with those of the regulators and other intervening parties. This can't be helped—regulation, by its very nature, is intended to change the outcome of what would have otherwise happened through competition (i.e., the voluntary actions of buyers and sellers in the market). This does not mean there is no place for government intervention, but it does mean intervention should be carefully targeted toward unethical, rather than competitive, behavior. The current hybrid Texas regulatory scheme does not do this. The two main reasons for this are found in the Staff Report:

State law clearly establishes a regulatory system that features both pre-market and post-market regulatory tools, with an overall intent to reduce oversight in the process for approving insurance rates. The current hybrid file-and-use system lessens regulation

standards, and should facilitate rapid use of rates and competition among insurers, while maintaining some safeguards to protect insurance consumers. However, TDI's use of both pre- and post-market regulatory tools prevented Sunset staff from drawing conclusions relating to the Legislature's shift to a market-based rate regulation system.

One reason for the sluggish regulatory response is "TDI's use of both pre- and post-market regulatory tools." TDI staff has significant leeway in how it implements statute and, for the most part, it has chosen to implement legislative reforms with a finger on the regulatory side of the scale. But, while the impact of TDI's implementation must be acknowledged, it is also true that "[s]tate law clearly establishes a regulatory system that features both pre-market and post-market regulatory tools." In other words, the statute itself is ultimately responsible for the ambivalent move toward reform.

One example of this is the statutory emphasis on "excessive" rates, which conflicts with other statutory provisions, such as those that 1) prohibit "inadequate" rates, 2) "promote the availability of insurance," and 3) "promote price competition among insurers."

This is where the Staff Report stops just short of the mark. For while it provides an insightful and accurate analysis of the problems, its recommendations on homeowners' insurance would simply modify TDI's implementation of the statute rather than change the conflicting provisions in the Code.

Legislative Issues

The Foundation identified the following three key issues that the Texas Legislature needs to address this session to bring a consumer-friendly regulatory system to the Texas homeowners' insurance marketplace:

Issue 1: Incomplete implementation of file-and-use rate regulation and conflicting statutory guidance on rate regulation create regulatory uncertainty, disrupt competition, and lessen insurance availability in the Texas homeowners' insurance market.

Key Findings

- Positive results are being realized in insurance markets embracing competition, including Texas.

- 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 and puts insurers at risk of insolvency.
- Allowing Texans to purchase out-of-state insurance policies would open up the Texas insurance market to more companies, increase consumer choice, and foster competition.

Recommendations

- Shift the focus of homeowners' insurance rate regulation to guarding against rates that are inadequate or discriminatory.
- Make the homeowners' insurance system a true file-and-use system.
- Allow the commissioner to place under prior approval only those companies whose financial positions warrant increased supervision, for the purposes of maintaining solvency.
- Allow Texans to purchase insurance policies offered by insurance companies not licensed in Texas yet licensed by other states' insurance regulators.

Issue 2: Regulation of policy forms disrupts innovation and efficiency in the homeowners' insurance market.

Key Findings

- Form regulation harms consumers through higher insurance costs that result from increased compliance costs for insurers. TDI's belated implementation of a 1997 provision allowing insurers to use forms other than the standard state form cost consumers almost \$900 million.
- As a result of TDI's belated implementation of a 1997 provision allowing insurers to use forms other than the standard state form, premiums rose dramatically. After TDI allowed insurers to use non-standard forms in 2002, mold claims plummeted, and rates stabilized. TDI acknowl-

edged that, without the deregulation of forms, rates could have increased at least 20 percent more than they did.

- 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 did not actually say this. However, the courts rejected the reasoning by TDI, in deference to the plain language of the forms.

Recommendations

- Implement a true file-and-use system for regulating policy forms.
- Focus policy-form regulation on the wording and clarity of an insurance form (i.e., how an insurer informs possible policyholders of the coverage provided under a form) and not on the content of a form (i.e., what risks are covered/insured under a form).

Issue 3: Overly broad authority to require information from insurers and examine rating practices hinders innovation and creates regulatory uncertainty in the homeowners' insurance market.

Key Findings

- The Code contains no safeguard(s) against TDI's requiring from insurers information that is proprietary or irrelevant to the rate filing at hand.
- The more information required by the commissioner from insurers—and the more often the requests for more information—the greater the time and expense to get rates to consumers.

Recommendation

- Limit the supplementary information insurers may be required to submit to TDI in a rate filing. ★

For a full analysis of these issues, please see the Center for Economic Freedom's August 2008 report, *Consumers, Competition, and Homeowners' Insurance* at www.texaspolicy.com.

