Policy Perspective
Texas Public Policy Foundation
February 2006

Is the Free Market Working for the Texas Homeowners' Insurance Market?

by Bill Peacock, director of the Center for Economic Freedom

Background

Early in this decade, skyrocketing homeowners' insurance claims and premiums had created both an economic and political crisis. Claims by Texas homeowners' insurance policyholders for mold damage began to skyrocket. From the first quarter of 2000 to the fourth quarter of 2001, the total number of mold claims grew from 1,050 to 14,706—a 1,300 percent increase.[1]

Mold claims were not only numerous, they were also expensive, averaging between $15,000 and $30,000 per claim. 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.[2]

In 2000, costs per policy exceeded premiums by almost $200. For 2001 and 2002, the numbers were over $700 and $300, respectively. Overall, homeowners' claims rose from $1.3 billion in 1999 to $2.9 billion in 2001.[3] In both 2001 and 2002, insurers paid out more in claims than they collected in premiums, with loss ratios of 116.9 percent and 108.9 percent, respectively.[4]

All of this took place despite the fact that for generations, Texans have dealt with water leaks and mold through regular maintenance, bleach and a little elbow grease. Mold toxins at indoor environmental levels have never been shown scientifically to cause any health problems or illness, nor are chronic diseases characterized by symptoms due to mold alone.[5] Perhaps a better explanation for the crisis was the adoption of asbestos-type tactics to pursue mold claims by members of the plaintiffs' bar and the subsequent media frenzy that scared many homeowners.

While insurance companies could do little to address these causes on their own, they attempted to respond to these worsening conditions in ways they could

Policy Recommendations

- The Texas Department of Insurance should focus on regulating solvency and market conduct and educating consumers.
- The Texas Legislature should develop a long-term plan for eliminating price regulation of Homeowners' Insurance.
- The Texas Legislature should provide clear statutory guidance to courts and regulators to ensure that contracts between insurers and their policy holders are not rewritten after the fact.

CONTINUED ON NEXT PAGE

control. Unfortunately, they were hindered by the Texas regulatory climate, and things became worse before they became better.

At the time, most insurers in Texas were required to offer homeowners' policies using the state's HO-B form, which mandated certain coverage, including water-related and mold damage. Insurance companies who sought to respond to control insurance costs by dropping mold coverage were prohibited from doing so by the regulations.

This left raising prices as the primary response available to the insurance companies. At the time, Texas officially used a "flexible band" benchmarking system to regulate homeowners' insurance that allowed price increases only within a narrow range. But Texas law also had a safety valve in place that allowed insurers to form Lloyd's facilities to manage their homeowners' line and offer competitive pricing of homeowners' insurance in a non-rate-regulated environment. Most of the companies that had not already utilized this option began to do so.

Not surprisingly, premiums began to rise, though not as rapidly as claims. From 2001 to 2002, collective homeowners' premiums increased 21.8 percent.[6]

By 2003, companies writing homeowners' insurance had declined to 101, down from 166 in 1997. Some of those who remained behind said that they would not write any new policies.

As the crisis worsened, companies also began to explore the options of not writing any new policies or leaving the Texas market altogether. Many companies chose one of these options. By 2003, companies writing homeowners' insurance had declined to 101, down from 166 in 1997. Some of those who remained behind said that they would not write any new policies.

The insurance companies' actions, in addition to some regulatory relief discussed in the next session, improved the market significantly. Premiums collected caught up with losses in 2003, and 2004 signaled a return to profitability. However, that one year did not make up for an average annual underwriting loss over the previous decade of 10.6 percent. And the 2004 level of profitability is unlikely to repeat in 2005 because of the damage caused by hurricanes Katrina and Rita.

The Current Regulatory Climate in Texas

The current regulatory climate for homeowners insurance was shaped by two key events related to the mold-induced crisis: the deregulation of insurance forms (coverage) in 2002 by the Texas Department of Insurance (TDI) and the passage of SB 14 by the Texas Legislature in 2003.

2002 – Deregulation of Insurance Forms

In 2002, insurers were trying to persuade TDI to allow insurers to use policy forms that were being used nationally by the companies. This had been authorized by the legislature back in 1997 in SB 1499. Prior to that, statute allowed only forms that were promulgated by the TDI. However, despite the evidence of mounting losses and questionable claims about the effects of mold in 2002, the department continued to move slowly on this.

The department did eventually approve coverage changes for most companies in 2002. However, the changes were delayed while the issue was studied and debated, adding to the already skyrocketing costs of insurers. In the case of the Farmers Insurance Group, the approval happened only after Farmers agreed to provide $100 million for homeowners' in restitution, refunds, and rate reductions. At the time of the agreement, Farmers was on the verge of leaving the Texas homeowners' market.

2003 – Senate Bill 14

In SB14, by Sen. Mike Jackson, R-La Porte, the legislature removed the Lloyd's exemption and placed all companies under state price regulation. Though the bill eliminated the flexible band rate regulation, it initially required TDI to review the homeowners' rates of insurers and authorized the commissioner of insurance to modify the rates if he found them in violation of the statutory rating standards enacted in the bill. And in August 2003, the commissioner did order 30 insurance company groups to lower their rates an average of 12.5 percent, at a cost to the companies of $500 million over the first year.

In order to avoid protracted litigation costs, most of the companies agreed to the rate cuts even though they maintained that they were in compliance with the rating standards. Twenty-two companies took a one-time reduction and six phased them in. But two of the companies, Farmers and State Farm Insurance, challenged the cuts in state district court. The challenge was successful, and the court granted a summary judgment against the state based on procedural grounds. Subsequent to the judgment, Farmers settled its dispute with TDI; but the department is still pursuing its legal battle with State Farm.

After this first phase of regulation, SB 14 called for a new "file and use" regulatory system that was implemented in December 2004. The file and use system allows insurers to immediately use new rates after filing them with TDI. This provision has the potential of creating a marketplace that allows companies to set rates based on competition with each other and consumer demand without unwarranted government interference.

> File and use has the potential of creating a marketplace that allows companies to set rates based on competition with each other and consumer demand without unwarranted government interference.

However, SB 14 also had a "subsequent disapproval" provision by which the commissioner may disapprove rates already in use and force rebates.[i] This "subsequent disapproval" provision is based on vague, subjective standards and is unnecessary. If "subsequent disapproval" is invoked with great frequency or with too long a lag after rates have been used, it would squelch the intended benefits of file and use, essentially making Texas a more regulated "prior approval" system. Without the "safety valve" previously furnished by the Lloyd's exemption, there is the potential for overregulation to once again limit the supply of insurers willing to write policies in Texas.

Is the Free Market Working for Homeowners' Insurance?

As the previous discussion indicates, there is considerable debate about whether Texas homeowners' insurance regulatory structure is truly a free-market approach. Rep. John Smithee, one of the architects of the current system, believes we have more of a supervised market today than we did before SB 14.[7] And while today's file and use system is certainly an improvement from the flexible band approach, the potential for overregulation along with the absence of the Lloyd's exemption is problematic. Despite these complexities, there are at least two ways of examining the impact of the free market on the homeowners' insurance market in Texas.

The Free Market at Work in 2002-2003

Prior to the passage of SB 14, there was a period of time when companies could take advantage of both the Lloyd's exemption and the relief from mandated coverage. This combination contributed significantly to bringing the insurance crisis to an end.

Mold claims plummeted in 2003, 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. For 2003, the de-

[i] A second SB 14, passed in 2005, added a provision that required interest to be paid on the rebates.

partment estimated that overall premiums increased by only 1.4 percent, much less than the 40 plus percent increase over the two previous years.[8]

There is other evidence that the forms deregulation and use of the Lloyd's exemption had a positive effect on the market before SB 14 was passed. For instance, 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."[9] The article went on to report, "In Dallas County, the average premium on a $100,000 brick veneer home with a 1 percent deductible is $990 for the 39 companies selling policies in the area. In May, the average was $979."

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.[10]

The free market clearly worked in Texas in 2002 and 2003.

The evidence strongly suggests that the market responses, made possible by the existence of the Lloyd's exemption and the reduction of mandated coverages, may have brought the homeowners' insurance crisis to an end before the legislature addressed the issue with SB 14. The free market clearly worked in Texas in 2002 and 2003.

The Return of Market Competition

Another way to judge the success of market reforms is to look at the competitiveness of the market today. In 2003, companies writing homeowners insurance had abandoned Texas in droves, declining from 166 in 1997 to 101. Additionally, several of the largest insurers had announced that they would stop writing new policies or perhaps leave the state altogether. It was hard to find homeowners' insurance at any price at the time.

In contrast, today's market looks very competitive. The market is less concentrated than it was, with smaller market shares for the largest companies and at least 17 new companies writing policies. Established companies are once again taking new customers. And there is a greater variety of prices and coverage being offered to Texas consumers.

The Herfindahl Index, a scale economists use to measure market concentration, shows that competitiveness in the Texas market has indeed improved. The index decreased from 1636 in 2000 to 1388 in 2003,[ii] suggesting that the 2002-2003 responses to the crisis fostered new competition in the market.[11]

Anecdotal evidence also suggests the competitiveness of today's market. Homeowners are getting bombarded by mailings and advertisements by companies trying to attract their business. Consumers can go to the TDI web site and compare prices and coverage from dozens of insurers.

Additionally, despite the increased competition, it appears that the market is returning to profitability. The latest figures show that in 2004, the industry's loss ratio plunged to 27.7 percent from the 2001 high of 116.9 percent.[12] The average return on net worth for the industry was a healthy 38.1 percent.[13]

While this news may not be pleasing to some industry critics, it is certainly good news for consumers who only a few years ago were wondering whether they would be able to find someone to sell them insurance at any price. It is this profitability that has brought new companies into the market and fostered the competition that consumers are experiencing today. This competitive marketplace means that consumers have choices. If they do not like the price they are paying or the product they are receiving, they can take their business elsewhere. Companies cannot "overcharge" their customers in Texas' competitive market.

[ii] A lower score means a more competitive market. A score of 10,000 represents a monopoly, while the U.S. Department of Justice classifies any score under 1,000 as unconcentrated.

It certainly appears that the ability of insurance companies to respond to market conditions without interference from regulators has been the key factor in shaping today's healthier, more competitive marketplace.

While it is difficult today to separate the benefits of reduced regulation of coverages from the harm caused by subsequent disapproval and unmerited lawsuits against the industry, it certainly appears that the ability of insurance companies to respond to market conditions without interference from regulators has been the key factor in shaping today's healthier, more competitive marketplace.

Answering the Critics

Recent news reports have included critical comments on the lack of price regulation in the homeowners' insurance market. Many of these were based on a report released in January by the National Association of Insurance Commissioners showing Texas with the highest average homeowners' rates in the country. However, there are two problems with the way the study's findings are being used.

One problem is that Texas is being singled out among the states even though the report warned against using the data to compare rates state by state because of the difficulty in comparing differing coverage and conditions across states. But most significantly, the criticisms of today's Texas homeowners' insurance market are based on data from 2003. There is no information in the report that can shed light on the Texas insurance market today.

The criticisms of today's Texas homeowners' insurance market are based on data from 2003.

There have been other, more well-considered calls for price regulation because of the market's alleged inability to properly regulate homeowners' insurance prices. Two such criticisms claim there is an inelastic demand for homeowner's insurance but large fluctuations in supply, along with a limited supply. Market critics contend that people have little choice but to buy a fixed amount of insurance, either because they are required to in order to get financing or because they are unwilling to bear the risk of losing the entire value of their home. They also assert that the high cost of entering the Texas homeowner's insurance market keeps the number of companies low.

However, there are many choices people can make *before* they purchase a residence that affect the demand for homeowners' insurance, including the type, location and cost of a home. People may choose to rent instead of buying. Additionally, once people purchase a home, they can affect the price of their homeowners' policy based on the types of coverage included in the policy.

Furthermore, the recent fluctuations in demand were almost entirely caused by the over-regulation of the market. In fact, a good argument can be made that the entire mold crises could have been avoided if TDI had moved more quickly to allow flexibility in coverage. When the government gets out of the way, there is generally a healthy, stable supply of providers in the homeowners' insurance market. As already noted, there are close to 120 companies writing policies in Texas today.

Other reasons used to justify price regulation of the market include consumer ignorance and "stickiness." According to these theories, consumers are too busy or overwhelmed by the complexity of the product, and thus can't really make meaningful choices in the market. This can be proven, critics claim, because of stickiness in the market, i.e., too many consumers staying with their original insurance companies even though there are cheaper alternatives.

However, consumers face other complicated activities, such as purchasing cars, computers and homes, and seem to fair just fine in these cases. There are few calls for regulating the prices of homes or cars. To the extent that consumers lack expertise, the marketplace offers them independent insurance agents to help them make informed decisions. And though many people claim that stickiness in the market means that consumers have not made an "affirmative choice" regarding their insurance provider, that claim is impossible to sustain. There is no basis for it in the data, and it ignores the fact that many consumers could have indeed made an informed, "affirmative choice" to stay with their current provider because of established relationships, superior service or more comprehensive coverage.

Conclusion

As it does everywhere, the free market benefits the Texas homeowners' insurance market when given a chance. While some people complain about the high costs in the Texas market, former Texas Insurance Commissioner Jose Montemayor said that 85% of the difference between Texas and national rates can be attributed to hurricanes, windstorm, mold and water damage.[14] Furthermore, 8 percent to 15 percent of premium dollars goes to underwrite the regulatory system.[15] Add in the previously demonstrated harmful effects caused by regulation, and it seems as if Mother Nature and government regulation are the primary causes of high insurance rates.

> As it does everywhere, the free market benefits the Texas homeowners' insurance market when given a chance.

The government's contribution to high rates is not surprising when the nature of rate regulation is examined. Once the numbers have been evaluated, rate regulation often comes down to simply a difference of opinion between the government's actuaries and officials and their counterparts at insurance companies. Even regulators acknowledge this to be the case, conceding there is a certain amount of leeway or a range where either sides' actuaries could be right.[16]

An illustration of this difference of opinion is displayed in a 2003 report by the Casualty Insurance Legislative Oversight Committee that stated, "The sum of [TDI's] conclusions indicates under-pricing prior to 2002, and a subsequent overcorrection on the part of the industry as a whole."[17] In other words, the report claimed that the entire homeowners' insurance industry in Texas was incapable of pricing its products correctly. Yet it must be noted that regulators did not step in to increase the under-priced rates prior to 2002, even though they are required by statute to "prohibit… inadequate rates."[18]

Another cause of market uncertainty which leads to higher costs is the tendency of the government to require insurers to cover damages not included in their policies. For instance, Mississippi Attorney General Jim Hood recently filed suit against insurance companies in his state attempting to force them to pay claims for water-related damage even though their policies specifically exclude that coverage. In Texas, TDI brought a lawsuit against Allstate to force them to pay for living expenses incurred by their insured after Hurricane Rita. The homes of the insured were not damaged, but they had trouble getting to their homes due to government restrictions, so they had to live elsewhere for a while. Allstate's policies specifically excluded this coverage. A state district court ruled against TDI. The rewriting of private contracts by government is not appropriate, and results in requiring companies to provide free coverage after the fact, since these costs are not factored into their rates and no premiums are collected to pay for them.

The following recommendations are designed to remove the uncertainty and instability that government price regulation brings to the homeowners' insurance market and allow the free market and regulators to each do what they do best:

- The Texas Department of Insurance should focus on regulating solvency and market conduct and educating consumers. To this end, TDI should:
  - adopt regulations for implementing file and use in the least regulatory form;
  - adopt regulations for using its subsequent disapproval authority only in exceptional circumstances; and
  - enhance the consumer tools on the TDI website.

- The Texas Legislature should adopt a long-term plan to eliminate price regulation and put the focus of regulation on solvency and market conduct. This would include:
  - eliminating all pricing standards relating to homeowners' insurance;
  - eliminating TDI's subsequent approval authority; and
  - ensuring that the use of improved risk predictors, like credit scoring, does not face statutory or regulatory obstacles.
- The Texas Legislature should provide clear statutory guidance to courts and regulators to ensure that contracts between insurers and their policy holders are not rewritten after the fact.

Bill Peacock is the director of the Center for Economic Freedom at the Texas Public Policy Foundation. Contact Bill Peacock at: bpeacock@texaspolicy.com.

For more information on Homeowners Insurance, see:

Deregulation, Pricing, and Availability

Issues In The Texas Homeowners' Insurance Market

By Patrick Brockett and Patricia M. Arnold

This study is available on the Foundation's website

www.TexasPolicy.com

Endnotes

[1] Michael C. Hotra and Kimberly A. Martin, *Mold for Gold*, Texas Public Policy Foundation (Oct. 2002) 1.
[2] Ibid, 2.
[3] Texas Coalition of Affordable Insurance Solutions, White Paper (2005).
[4] Texas Department of Insurance, Chart: "Texas Homeowners' 10 Year History of Losses as a Percentage of Premium" (Jan. 2006).
[5] Ronald E. Gots "Correcting Mold Misinformation." Presented at Mold Medicine and Mold Science Conference (May 2002).
[6] Texas Department of Insurance, Homeowners Chart.
[7] Rep. John Smithee, remarks at the Texas Public Policy Foundation's 2006 Policy Orientation (Jan. 2006).
[8] Texas Department of Insurance, SB 310 Summary Report for the 78th Legislature: Final Report (Mar. 28, 2003) 7.
[9] *Dallas Morning News*, (Aug. 29, 2002).
[10] Texas Department of Insurance SB 310 Report, 2.
[11] Patrick Brockett and Patricia Arnold, *Deregulation, Pricing, and Availability Issues in the Texas Homeowners' Insurance Market*, Texas Public Policy Foundation (Dec. 2004) 22.
[12] Texas Department of Insurance, Chart: "Texas Homeowners' 10 Year History of Losses as a Percentage of Premium" (Jan. 2006).
[13] National Association of Insurance Commissioners, "2004 Profitability Report" (Dec. 2005).
[14] Texas Department of Insurance, *TDInsight* (June/July 2004).
[15] Ernst Csiszar, president, Property Casualty Insurers Association of America, remarks made at the 2004 Mid-year Property and Casualty Insurance Symposium, Austin, Texas (July 15, 2004).
[16] Commissioner Mike Geeslin, remarks at the Texas Public Policy Foundation's 2006 Policy Orientation (Jan. 2006).
[17] Texas Property and Casualty Insurance Legislative Oversight Committee, "Interim Report to the 79th Texas Legislature," 11.
[18] Sec. 1 of Art. 5.13-2, Texas Insurance Code.

We Need Your Help

The Texas Public Policy Foundation is a non-profit, non-partisan research institute guided by the principles of limited government, free enterprise, private property rights, and individual responsibility. We seek to improve Texas government by producing academically sound research on important issues offered to policymakers, opinion leaders, the media, and general public.

We do not accept government funding or sell research outcomes; therefore, we rely solely on the generous contributions of individuals, foundations, and civic-minded corporations.

If you believe studies like this are important for Texas, won't you consider a financial gift to support the Foundation and our mission?

Give generously today by visiting us online at:

www.TexasPolicy.com

The State of Texas offers the following resources to help consumers shop for homeowners' insurance:

Texas Department of Insurance Website
http://www.tdi.state.tx.us/consumer/txshoph.html

Office of Public Insurance Council Website
http://www.opic.state.tx.us/homeowner.php

Texas Public Policy
FOUNDATION