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Modernizing the Texas Insurance Marketplace

by Bill Peacock &
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RECOMMENDATIONS

- Implement a regulatory emphasis on fairness and solvency at TDI.
- Deregulate homeowners' insurance rates.
- Allow Texans to buy homeowners' insurance from companies licensed in other states.
- Adopt the concept of an optional federal charter.

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COMPETING APPROACHES TO INSURANCE REGULATION

Historically, the basis for rate regulation for personal lines of insurance such as auto and homeowners' insurance was to ensure company solvency. Thus, rate regulation was focused on the adequacy of prices and often provided rate floors that companies could not undercut. While this approach has some anti-competitive features, it generally provided for the efficient operation of insurance markets.

However, since World War II, rate regulation has focused more on the need to provide affordable pricing by providing rates that are "adequate, not excessive, and not unfairly discriminatory."[1]

This approach to regulation turns on the notion that without government oversight, insurance companies will engage in price gouging at the expense of the consumer. Policymakers fear insurance companies will set premiums using market power, rather than rates being based on risk and subject to the downward pressure of market competition. Those favoring regulation often claim it is necessary because consumers cannot possibly understand what they are paying for and how to get the best deals in such a complex industry. In addition, because some forms of insurance are mandatory, or at least socially desirable, government regulation attempts to guarantee affordable coverage for more people. Finally, regulation tries to prevent insurance companies from offering rates that disadvantage certain groups of people.

Regulation has largely been at the state level since 1945 when Congress passed the *McCarran-Ferguson Act* to limit federal control over the industry in favor of state regulation. Although the Act eliminated federal oversight, it also created a system whereby insurance companies must adjust to 51 different regulatory schemes across America at a significant cost to consumers.

Today, the focus of these World War II era-legacy regimes is to maintain affordability. However, in pursuit of low rates above all else, the regulations have 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."[2] That is, regulation today disrupts consumer choice and results in inefficient and anti-competitive pricing.

While regulations may in fact create lower rates for some high-risk customers, they achieve this by increasing rates for low-risk consumers. "This smoothing effect decreases incentives for high-risk consumers to control their risks, thereby increasing losses and premiums for the entire insured population."[3] Low rates are also achieved by focusing only on the present and ignoring past costs and future risks.

Another problem with regulators' focus on affordability is that insurance companies have little reason to reduce costs through efficient operation or innovation.[4] Price controls place a specific value on a service or product, reducing the ability of companies to profit from innovations. Additionally, when companies take on more risk, regulators often refuse to allow those costs to be recovered. The best bet for companies is often to forego innovation and risk-taking and accept the government-determined rate of return—the same model that led to decades of technological stagnation in the electric utility industry.

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A modernized insurance market would look very different. Revamping the archaic state regulatory structures would allow insurance companies to better assess risk, protect their capital, and thus be more willing to enter new markets and innovate. The resulting increased competition will improve pricing and create additional incentives for innovation. Prices are pushed toward the marginal cost level of the most efficient firm. Consumers can make choices based on their best interests.

Talking*Point*:

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The basis for modernizing insurance markets is not limited to economic theories and models. Illinois has adopted 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.[5] The results speak for themselves.

A study that compared Illinois' auto insurance market to other 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."[6] The automobile residual market* in Illinois also routinely ranks well below the national average.[7]

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 (*see* Table 1). All signs from the Illinois insurance industry point to a healthy, stable, and thriving marketplace that benefits consumers.

Another case study is 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.[8] 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 residual market pool that decreased rapidly.[9‡]

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.[10] Empirical evidence shows free market competition is the most cost-effective and consumer-friendly method to reform the insurance industry.

HOMEOWNERS' INSURANCE IN TEXAS

Texas has generally been a national leader in promoting limited government and unleashing market forces to bring investment and growth. However, insurance regulation here has trended more towards regulatory intervention than free-market reforms.

Earlier this decade a combination of severe weather, skyrocketing mold claims, and regulatory inflexibility brought the Texas insurance market to a crisis point. From the first quarter of 2000 to the fourth quarter of 2001, the total number of mold claims grew

* Residual markets provide coverage for consumers that are unable to buy coverage in the voluntary market. A dysfunctional industry will have a higher number of consumers in the residual market.

† Market concentration is measured on a scale called the Herfindahl-Hirschmann Index (HHI). Generally, as scores approach 10,000, the greater the indication of anti-competitive or monopolistic behavior. A score of less than 1,000 represents an unconcentrated, and thus very competitive market.

‡ In 1996 there were 74 companies offering insurance in South Carolina, while that number grew to 156 insurers in the year 2000. From 1998 to 1999, the residual market decreased by 70%, while the voluntary market increased 36%.

from 1,050 to 14,706.[11] Premiums rose too, but not fast enough to match the claims. In fact, in both 2001 and 2002, insurers paid out more in claims than they collected in premiums.[12]

In 1997, the Legislature had authorized TDI to allow insurers to use national policy forms instead of state-mandated forms. However, despite the evidence of mounting losses from questionable mold claims, the department moved slowly to enact this reform.

The department did eventually approve coverage changes for most companies in 2002. However, this was after a filing from State Farm Insurance had languished for almost five years. 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. They were not alone. From 2000 to 2003, companies writing homeowners' policies in the state shrank from 137 to 101.[13]

The market responded positively to these developments. Rates stabilized and capital began to flow back into the market. The HHI showed competition improved as the index decreased from 1636 in 2000 to 1388 in 2003 (*see* Table 1).

In 2003, the Legislature acted to address a crisis that had already largely passed due to the loosening of regulations on forms. SB 14 removed the Lloyd's exemption* under which most companies had been able to set rates without regulatory oversight and placed all companies under state price regulation. After an initial period during which all rates were subject to modification by the insurance commissioner, the legislation called for a new file and use regulatory system that was implemented in December 2004.

Table 1

Comparing market concentration for homeowners' insurance in Texas and Illinois (using HHI):[14]

Year	Texas	Illinois
2000	1636	1271
2001	1611	1255
2002	1458	1320
2003	1388	1301

While a file and use statutory system can be very free-market oriented, this ultimately relies on the regulators. In Texas, the implementation has leaned towards regulatory intervention rather than laissez-faire, effectively turning the file and use system into a de facto prior approval system.

Recent examples of this are the decisions this summer by Farmers Insurance and Allstate Insurance to withdraw their proposed homeowners' insurance rate filings in the face of opposition from TDI.

Allstate's filing sought to account for rising construction costs since Hurricane Katrina that have increased the costs of claims. Farmers' filing sought to differentiate the rates paid by homeowners in areas of the state with less risk, including North Texas, from those who live in high risk areas, such as the hurricane-prone Gulf Coast.

In both cases, TDI indicated it would not approve the filings.

"The increases are heavily weighted toward the coast, which may be appropriate because of the risks," said TDI spokesman Ben Gonzales. "But we need to see more documentation."[15]

Even more recently, TDI rejected a subsequent rate filing by Allstate and subjected all of its future filings to prior approval.

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* In addition to the "flexible band" or benchmark system in place at the time, Texas also had a safety valve that allowed insurers to form Lloyd's facilities to manage their homeowners' line and offer competitive unregulated rates. The vast majority of the market had moved to utilize the Lloyd's exception by 2003. By providing an avenue for companies to recover their growing losses during the mold crises, the exception proved invaluable in keeping insurance available in Texas at any cost.

TDI's implementation of the file and use system has forced ratepayers across the state to subsidize both homeowners' and windstorm policies along the coast and has diverted resources from ensuring the solvency of companies. 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.

Most importantly, TDI's regulatory stance has significantly reduced the ability of insurers to account for risk in pricing their policies. Insurers assess risk years into the future, but today can't even safely predict what their income will be next year. This has a chilling effect on Texas' ability to attract capital and new insurers; over time, the absence of both will keep rates artificially inflated.

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INCREASING COMPETITION IN THE TEXAS HOMEOWNERS' INSURANCE MARKET

Four main options are available for modernizing the Texas insurance marketplace: 1) implement a regulatory emphasis on fairness and solvency at TDI, 2) deregulate rates along the lines of Illinois, 3) adopt state legislation that allows Texans to buy insurance plans from companies that are domiciled or licensed in another state, or 4) support federal legislation for optional federal charters that allow insurance carriers that choose to be regulated by the federal government to offer policies in all 50 states.

I. Implement a regulatory emphasis on fairness and solvency at TDI

For at least the last decade, TDI has generally emphasized short-term affordability over fairness and solvency. While this paper has already discussed the harmful manifestations of this approach, a review of the research will show why this approach has failed.

Regulators cannot satisfactorily determine affordable prices because there is no way for them to obtain the necessary data.[16] This may seem counter-intuitive with the army of actuaries on hand at TDI, but in fact no single market participant can set prices efficiently outside of the market process. "Current regulation and reform proposals tend to view government regulation as an alternative to the market in discovering competitive costs and prices. The competitive process, however, cannot be simulated and competitive costs and prices can only be determined by having competition."[17] TDI's unwillingness to allow companies to actually file and use rates has made it impossible to determine the fairness, i.e., efficiency, or adequacy of rates.

This conclusion is supported by research identifying another defect in the pursuit of affordability. Since regulators cannot control the underlying costs and risks associated with homeowners' insurance, it is impossible for them to promote fairness and solvency when they are trying to make subjective determinations of affordability. Regulators are forced to turn to wealth redistribution through subsidized rates for high risk consumers in response to rising costs.

"Such a system of implicit subsidies is viable only in the short run because the highly competitive nature of insurance markets means that the higher rates on some services needed to support the subsidized rates on others will tend to be competed down by rivals. But if the regulated system of implicit subsidies is not viable, then the wealth redistribution itself cannot be maintained without a steady erosion of insurer solvency."[18]

In order to fully implement a regulatory approach emphasizing fairness and solvency, TDI will have to make changes in the following areas:

- **Homeowners' rates**– TDI should not reject rates before they are filed and used. Only after being subjected to competition can the fairness of rates be properly determined. Additionally, TDI should not reject rates based solely on subjective deter-

minations by its actuaries. It should also consider the position of the rates within the market. Many of the rates that TDI has challenged have actually been in the middle of the rates in use by homeowners' insurers in Texas.

- **Windstorm Insurance**– For years, TDI has kept the Texas Windstorm Insurance Association's rates well below what is needed to cover losses from the landfall of even a mid-sized hurricane in Galveston Bay. Insurance companies and, ultimately, taxpayers are on the hook for billions of dollars in payouts for damages. The inability of companies to accurately forecast their liabilities under this scheme is a major deterrent to new capital investment in Texas. An upcoming Foundation paper will examine this issue thoroughly, but for now it is enough to say that TDI should allow TWIA's rates to increase substantially.
- **Forms–** TDI's challenges with forms didn't end with the mold crisis. 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. This is reminiscent of lawsuits earlier this decade in which trial lawyers were able to get a court to reinterpret forms to include coverage for mold. However, in this case, the courts rejected the reasoning by TDI in deference to the plain language of the forms. For the most part, TDI should leave the enforcement of forms, i.e., contracts, to the parties involved and the courts.
- **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. It is not clear what if anything TDI could have done to prevent this situation. What is certain, however, is while one company went out of business because its rates were inadequate, TDI was expending significant resources trying to force other companies to lower their rates. TDI should redeploy significant resources away from its current emphasis on affordability to efforts to ensure the solvency of Texas insurers.

II. Deregulate homeowners' insurance rates

Lawmakers should follow the lead of Illinois by removing rate regulation of homeowners' insurance. The resulting competitive environment would induce more carriers to enter the Texas market and increase insurance availability to consumers across the state. Texans would benefit from a free market in which prices are determined by supply and demand, efficient business models, innovation, and capital investment.

Allowing the insurance industry to operate without rate regulation, however, does not mean leaving the consumer without any protection. For example, the Illinois Division of Insurance—much like TDI—is authorized to regulate insurance solvency and market conduct. Since the department does not regulate rates, it saves taxpayer money by focusing its efforts on other aspects of the industry "that are more widely regarded as being useful and necessary."[19]

In implementing a regulatory regime without price regulation, Texas should focus its resources on implementing its authority like Illinois' to monitor solvency and market conduct. In addition to state regulation, insurance activity would also be monitored under the *McCarran-Ferguson Act*, which stipulates that when a state decides not to adopt regulation, federal antitrust laws apply as they would for the rest of the national economy.[20]

In addition to the beneficial impact on Texas consumers, the significance of this proposal to taxpayers should not be overlooked. TDI is scheduled to spend over $20 million dollars this biennium directly on licensing and regulating rates and forms—with millions more being spent on administrative and technological support. While this covers a wide range

Talking*Point*:

Fostering regulatory competition will cause firms to domicile in free market states such as Illinois—and Texas, should it choose to deregulate rates.

of insurance products, there is no doubt that significant resources are spent on maintaining the ability to regulate homeowners' insurance rates. Deregulating rates on homeowners' insurance could also lead to similar actions in other lines of insurance, further reducing expenditures by TDI.

III. Allow Texans to buy plans from companies licensed in other states

In addition to eliminating rate regulation, Texas should adopt the principles of a bill proposed on the national level aimed at increasing health care insurance availability across the country. 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 insurance policies that are licensed in other states.

Talking*Point*:

Under the optional federal charter, insurance companies will be able to choose federal or state regulation.

The Legislature could adopt legislation that is based on this proposal by allowing Texans to purchase 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."[21] Texas consumers that purchase plans from out-of-state providers would be afforded protection as prescribed by the licensing state.

Although states where insurers are licensed would retain the primary authority to regulate insurance providers, lawmakers could ensure that market conduct would still be subject to Texas' consumer protection laws.

Solvency of companies is closely watched by states across the nation. Standards for company solvency by the National Association of Insurance Commissioners (NAIC) have had a significant impact on ensuring uniform standards and focus on solvency concerns by state regulators.

Texas could save taxpayer money and reap the benefits of increased competition by allowing other states to license and regulate insurance companies at little or no expense to its citizens.

There are some challenges to this approach that must be dealt with. First, many of the previously mentioned regulatory problems at TDI that are currently hindering competition in the insurance market would still be a problem under this approach. Unless these problems are addressed, companies from other states may be no more willing to sell insurance in Texas under this proposal than in the current situation. Second, the differences between property and casualty insurance and health insurance will require some adjustments as well.

Despite these hurdles, the benefits of this approach may be enough to allow it to succeed. The rise in Internet availability and proficiency will allow citizens in search of insurance to easily access and compare rates from across the country. Forcing competition beyond just the 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 may be enough to entice companies to participate.

IV. Adopt the concept of an optional federal charter

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 this year 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 state licensed insurance carriers could sell insurance within the state in which it holds a license. 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.

Life insurance would be subject to a "file and use" system, while property/casualty insurance would be under a "use and file" system. Both would eliminate any prior approval mechanisms. The federal charter would differ from the Texas "file and use" system because it is unlikely that companies opting for the federal charter would be subject to subsequent rate disapproval which has proven to create regulatory uncertainty within the state.

For the most part, insurance companies electing for a federal charter would be subject to federal laws. However, some state laws will apply such as: 1) tax law, 2) unclaimed property and escheat laws, 3) laws relating to assigned risk plans and residual markets, and 4) laws that provide for compulsory coverage of workers' compensation or motor vehicle insurance.

An independent Office of National Insurance would be created to monitor the conduct of federally chartered insurance companies. The companies would be subject to risk-based capital standards, investment standards, and asset and liability valuation requirements. Further, federally chartered companies would be subject to examinations every three years, and in response to complaints or evidence of regulatory violations.

The commissioner of the Office of National Insurance would maintain the power to enforce these guidelines through a variety of mechanisms including revoking charters or licenses, imposing fines of up to $1 million a day, issuing cease and desist orders, and removing or suspending officers, directors or other individuals.

The *National Insurance Act* would also create a Division of Consumer Protection within the Office of National Insurance to monitor market conduct, competition and prevent fraudulent or deceptive business practices. Federal antitrust laws will be applied to companies receiving a national charter. All federally licensed companies will also be forced to join a state's guaranty funds. If a particular state's guarantee association does not meet NAIC standards, then the company will be required to join the National Insurance Guaranty Corporation in order to provide protection for policy holders.

A recent study on the optional federal charter conservatively estimated that it would reduce costs for life insurers by more than $5.7 billion a year.[*]

The benefits of unified market and consistent regulatory standards have led to support for the *National Insurance Act* from a long list of organizations.[†] However, concerns that it will open the door to too much federal oversight and create opportunities for excessive federal

Quick*Fact*:

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[*] The study, released on May 30, 2007, was conducted by Steven Pottier, an associate professor of insurance at the University of Georgia's Terry College of Business. It was sponsored by the American Council of Life Insurers.

[†] Groups that have expressed support for the act include: Agents for Change, American Bankers Association, American Bankers Insurance Association, American Council of Life Insurers, American Insurance Association, Council of Insurance Agents and Brokers, Financial Services Forum, Financial Services Roundtable, Life Insurers Council, National Association of Independent Life Brokerage Agencies, and Reinsurance Association of America.

intervention have led other organizations to oppose the bill.‡

With proper oversight, limitations and organization, the federal charter can be an effective means to foster competition at the national level and result in lower rates and higher availability. Although many Texans might prefer to deregulate insurance at the state level, the optional federal charter nevertheless presents a viable option for Texans who want to embrace free markets and allow competition to increase efficiency and decrease prices.

Talking*Point*:

Insurance modernization will provide for a competitive market that operates effectively and efficiently.

CONCLUSION

Insurance modernization will provide for a competitive market that operates effectively and efficiently. All four recommendations in this paper apply this concept to Texas' growing state insurance problem. The preferred option would be to deregulate the industry at the state level. This would avoid any possibility of intrusive federal oversight while fostering competition within the state such that Texans would have lower consumer prices and more independence to choose plans they prefer. However, it has become increasingly apparent that in spite of growing empirical evidence in areas such as Illinois, South Carolina, and the District of Columbia, many Texas policymakers still think it is necessary to heavily regulate insurance prices.

If rate deregulation cannot be achieved, then two other viable options are available to Texans. First, competition can be fostered by adopting legislation allowing out of state companies to sell insurance within Texas (this option would also be useful if rates are deregulated). Not only would consumers benefit from more efficient pricing, but taxpayers would benefit from reduced spending on licensing and regulation as other states would bear some of these costs. Texans would still be under the umbrella of Texas consumer protections laws relating to issues such as fraud. As an alternative to state-based competition, the optional federal charter would similarly provide for expanding consumer choices in the insurance marketplace.

Strict regulatory regimes are an outdated and misguided attempt to increase consumer welfare. It has been estimated that consumer welfare gains from regulatory reform across the country in the natural gas, long distance, airline, trucking and railroad industries have created annual consumer benefits in excess of $50 billion.[22] With the growing empirical evidence highlighting the successes of deregulation in a variety of locations and markets, implementing this approach in Texas is certain to benefit Texas consumers and taxpayers. ☆

‡ While the National Association of Insurance & Financial Advisors (NAIFA) has yet to take a stance on the bill, other organizations such as the National Association of Mutual Insurance Companies (NAMIC), Jackson National Life Insurance Company, the National Association of Life Companies (NALC), state insurance commissioners, and the National Governors Association are opposed to the bill.

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