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Non-Renewal of Policies in Texas' Homeowners Insurance Market

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Key Points

- Excessive regulation is one reason Texas has some of the highest homeowners insurance rates in the country
- Current law on non-renewals drives up the cost of homeowners insurance for most Texans, forcing them to subsidize the risky behavior of a select few.
- Relaxing the restriction on non-renewals will increase competition and reduce the cost of homeowners insurance.

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Introduction

Texas lawmakers have made meaningful progress over the last decade in reforming Texas law to better reflect the competitive market. The electricity and telecommunications markets, for example, have both seen a reduction in the level of government intervention, with the result that consumers now enjoy lower prices, greater choices, and better protection than they did when the market was under the government's heavy hand.

That progress, however, has not been shared in the homeowners insurance market, where Texas consumers pay insurance rates far above the national average. Indeed, the Texas homeowners insurance market is uncompetitive as compared to the nation as whole (Lehmann 2013 p. 14-17; Lehrer 2011 p. 16-17). One reason for this is Texas' vulnerability to extreme weather events; a more pressing reason sits in the government's persistent micromanagement of homeowners insurance contracts.

The Texas homeowners insurance market labors under heavy and disruptive government regulation. After more than a decade since the 2003 reforms, Texas still doesn't have a full file-and-use rate regulation system in place. In addition, Texas' non-renewal law, which restricts an insurer's ability to discontinue high-claim policies, forces insurance companies to make business decisions that reflect the government's policy preferences and not the companies' assessments of actual risk. The result of these and other interventions is a complex and anti-competitive regulatory regime, which reduces consumer choice, discourages innovation, and obliges consumers to shoulder the costs of the irresponsible, and sometimes fraudulent, behavior of other policyholders—a regulatory regime that stands at odds with Texas' free-market reputation.

Texas lawmakers cannot evade Texas' exposure to extreme weather, but they can improve Texas' insurance code and, through targeted reform, alleviate the costly burden that unnecessary and intrusive regulations have on the homeowners insurance market. Specifically, experience has shown that non-renewal laws have an adverse impact on the prices and services offered to consumers. Non-renewal laws interfere with the ability of insurers to assign rates that are commensurate with a policy's actual risk; they also prevent insurers from self-correcting any inadvertent overexposure, all of which works to drive up the cost of insurance and reduce consumer choice. As such, Texas lawmakers could make significant headway in reducing prices and increasing competition by loosening the restrictions on when an insurer can discontinue or add a premium surcharge to policyholders based on their claims history.

Texas Homeowners Pay High Insurance Rates

Properly designed, insurance policies help promote financial stability. They allow individuals to manage risk by exchanging uncertain, erratic, and potentially large losses with a fixed premium (Avram 2010, p. 6). In other words, insurance gives individuals security in their investments by guaranteeing a return if the worst should happen. It is this security that makes long-term planning and investment possible since individuals know that their resource-heavy investments, such as their homes, will not be eliminated by a bout of bad luck (Peacock 2013, p. 1; Avram 2010, p. 6-7).

If an insurance market is inefficient, however, the resulting high prices could make this security unattainable, depriving individuals, especially those of limited means, of a way to protect their assets or even the ability to invest in the first place. As a result, keeping the cost of

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insurance low, and therefore accessible, has been a chief concern behind homeowners insurance regulation.

Nevertheless, along with Florida and Louisiana, Texas consistently has some of the highest homeowners insurance rates in the country—conditions which are only exacerbated by the state's habit of preventing insurers from basing their business decisions on actual risk. As of November 2013, Texas homeowners paid an average insurance rate of $1,070, as compared to the national average of $846 (Home Insurance Rate Report 2013). This means that Texans paid around 28 percent more for coverage. Recent news reports also underscore that the most commonly sold policy in Texas was listed at $1,578, well above the national average of $978 (Stutz 2013).

The reasons for these high costs are varied. Part of the blame can be traced to Texas' unique vulnerability to destructive and catastrophic weather. Texas has some of the severest weather in the nation, and whether it's from tornadoes, wildfires, floods, thunderstorms, or hurricanes, homeowners throughout the state remain susceptible to large economic losses that their policies are bound to reimburse. From 2006 to 2011, close to 57 percent of homeowners insurance payments went to cover catastrophic claims (TDI 2012, p. 8).

That number could continue to rise as more and more Texans settle along the shore. Approximately 5.9 million people now live along Texas' coastal areas, with many regions seeing a corresponding boom in median home values (Fischetti and Wilson 2010, p. 9). In 2012, Texans had insured nearly $1.18 trillion in costal property—that's $1.18 trillion subject to the strong likelihood of storm damage and $1.18 trillion that insurance companies must find a way to underwrite if the worst should happen (Insurance Information Institute 2012).

Turbulent weather, however, only represents a single hurdle in the pursuit of low-priced insurance. Texas' law and regulatory regime consistently impose on the market the preferences of special interests in place of insurers' actuarial assessments and the preferences of consumers. By eliminating the natural price signals of a competitive market through restrictions on prices and policy renewals, it decreases the efficiency of the market and drives up capital costs, bringing about the opposite result of what the law is allegedly attempting to accomplish—lower prices and greater access.

Texas' Restrictions on Surcharges and Nonrenewal

One result of Texas' restrictions on the pricing of policies according to risk is that insurers are forced to spread the costs of high-risk policies throughout their customer base as they attempt to recoup otherwise avoidable losses, thereby artificially inflating homeowners insurance rates. The restrictions also encourage policyholders to engage in riskier decision-making with respect to their property, such as settling closer to the coast or failing to make basic repairs—again artificially inflating the price of homeowners insurance as the increased losses are socialized among Texas consumers.

The most well-known instance of this type of cost shifting is windstorm insurance. Texas consumers—and even taxpayers potentially—throughout the state have to subsidize inadequate windstorm rates along the Texas coast (Brannan and Peacock 2010).

Another less known but similar example is Texas' restrictions on the non-renewal of high-claims insurance policies.

The term "non-renewal" refers to a practice whereby an insurance company declines to renew a policy once the contract period has expired. This is distinct from a "cancellation" where a policy is terminated before the expiration date. With a non-renewal, all contract obligations are met and policyholders are given timely notice to seek a new provider. Moreover, non-renewals do not carry the same stigma as a cancelled policy since there are lots of reasons why a party may decide to non-renew a policy and many of these reasons are unrelated to the other party's behavior and/or fault. For example, an insurer may decide to non-renew a policy because risk conditions in the area have changed, or because the policyholder submitted too many small claims, or because the insurer wants to focus their business on specific types of insurance. Likewise, a policyholder may wish to non-renew a policy if their need for coverage changed or if they found a more cost-effective policy elsewhere. In any case, a decision not to renew indicates that the existing policy terms no longer complement the parties' economic needs and may no longer represent the most efficient means of acquiring and/or providing insurance.

Texas law, however, severely curtails an insurer's ability to non-renew existing insurance policies and, hence, their ability to pursue the most economical means of providing insurance. Chapter 551 of the Texas Insurance Code provides that "an insurer may [only] refuse to renew an insurance policy if the insured has filed three or more claims under the policy in any three-year period" (Texas Insurance Code Sect. 551.107(d)). The non-renewal is valid only if the insurer notified the policyholder after the second claim that the insurer may refuse to renew the policy if a third claim is filed. In addition, the Code also provides that "[a]n insurer may [only] assess a premium surcharge at the time an insurance policy is renewed if the insured has filed two or more claims in the preceding three policy years" (Texas Insurance Code Sect. 551.107(c)).

Importantly, the code makes no provision for when the increased hazard comes about because of the insured's irresponsible actions or negligent oversights, and the number of claims excludes any damages that are the result of natural causes. This means insurers cannot readjust a financially toxic risk pool by taking defensive action against a policyholder who overuses the claims process, even if the damages are the result of the policyholder's own misbehavior. Instead, insurers must direct their compensatory actions at their customer base more generally. It also means that policyholders lose their incentive to take preemptive actions to protect their property or to avoid negligent and/or fraudulent behavior with respect to the claims process since the prohibition on non-renewals and premium surcharges insulates policyholders from the costs of their behavior. As a consequence, insurers are prohibited not only from aligning their risk exposure to their actuarial needs but also from finding an intermediate position that allows them to continue offering coverage but at a price that accurately reflects their actual risk and encourages good claims behavior.

Excessive Claims Disrupt Risk Calculations

Consumers who file excessive claims on their homeowners insurance policies distort an insurer's risk calculation. According to the Texas Department of Insurance, Texas has over 4 million homeowner's insurance policies currently in force (TDI 2009b). For the vast majority of these policyholders, the insurance process works as it should. Homeowners pay a premium to cover damages from low-likelihood events, and insurance companies pool together properties with similar risks to diffuse the resulting costs among a large population (Cooter and Ulen 2008, p. 52-53). Homeowners are able to secure their high-value assets and investments, and insurers are able to make money by collecting enough premiums to cover any submitted claims plus their capital expenses.

There remains, however, a noteworthy minority of policyholders—two percent according to State Farm's internal findings—that either abuse or overuse the claims process (State Farm). A portion of these policyholders engage in fraud. The 2012 Annual Report of the Texas Department of Insurance Fraud Unit revealed that homeowners insurance fraud represented 13 percent of the number of the department's referrals to prosecution, the second highest of all referral types (TDI Fraud Unit 2012, p. 6). Other policyholders fall into a pattern of bad habits and irresponsible behavior that cause them to experience unnecessary losses, such as not fixing a known problem on their property, or result in the filing of multiple small claims.

Regardless of their motivation, by taking a disproportionate amount of claims money, these policyholders disrupt an insurer's risk calculations, undermining what was once an actuarially sound risk pool. Insurance companies rely on the law of large numbers in order to find the right mixture of population and risk that lets them pay off their claim as well as generate a profit (Ben-Shahar and Logue 2012, p. 202; Avram 2010, p. 7). The makeup of that mixture depends on an extensive and detailed calculation that assesses a variety of consumer, environmental, and regulatory risk factors, in addition to the performance of the financial market. Once the calculations are complete, insurers can create specialized risk pools, where ideally people with similarly situated risks are charged similar premiums (Powell 2008, p. 2). Fraudulent and irresponsible behavior, however, cannot always be predicted in advance and very often only become known once the policy has been issued. As such, insurers occasionally issue policies based on incomplete or incorrect information that causes them to miscalculate a risk pool's makeup and insurance rate.

The problem with these high-claim policies is that insurers put them into the wrong risk pool with lower premiums than their actual risk warranted. This means that the policy becomes a net loss for the insurance company, reducing their capital. If an insurer has too many of these policies, the premiums of other policyholders cannot cover the submitted claims, putting the firm at risk of insolvency and other consumers at risk of having their claims unfilled—one reason why Texas law requires that insurers establish rates based on actuarially sound principles and prohibits rates that endanger the insurer's solvency (Texas Insurance Code §§ 2251.051(d) and 2251.052(e)). Thus, although these uneconomic policies represent a minority of consumers, the costs they incur can upset an insurer's risk calculation to the detriment of both the insurance company and other policyholders. Accordingly, an insurance company must self-correct either by discontinu-

Texas state law curtails the ability of insurers to self-correct their risk exposure, driving these companies to pass along the increased costs of high-risk policyholders to lower-risk policyholders.

ing the money losing policy or by moving them into a higher premium plan. State regulations, however, interfere with this market readjustment.

Current Regulations Disrupt the Market's Self-Correction

Texas state law curtails the ability of insurers to self-correct their risk exposure, driving these companies to pass along the increased costs of high-risk policyholders to lower-risk policyholders. Insurance companies have a legal responsibility to both their policyholders and their shareholders to earn a sufficient sum of returns that allows them to attract the necessary capital to stay in business and pay off future claims. To do this, they must ensure that the risk they take on is balanced by the amount of premiums they collect—something they accomplish by either lowering their risk exposure or by increasing their returns, primarily through higher premiums.

Insurance companies have three options when faced with a money losing policy: they can hold the policyholder accountable by refusing to renew the policy or adding a surcharge once the terms naturally expire; they can raise the rates of all their policyholders both to compensate for the heightened risk and to recoup the extra losses; or they can stop offering coverage to an entire region if the companies can no longer guarantee their ability to meet their liabilities. The former option places the financial burden on the policyholder who engaged in the fraudulent and/or irresponsible behavior; the latter two penalize all consumers for high-claim policies either by making them pay a higher premium or by making it harder to obtain coverage. Texas' non-renewal law pushes insurance companies towards the latter.

Texas' Non-Renewal Law Hurts Most Consumers

On the surface, prohibiting non-renewals seems attractive because, actual consequences aside, they give the appearance of shielding consumers from the possible loss of their insurance and thereby the means to protect their largest investment, the family home. As mentioned above, the ability to have insurance gives individuals the confidence to make big purchases like a house because, without it, there is no guarantee that an investment will survive a bout of bad luck. Losing access to insurance, therefore, could keep lower-and-middle income Texans from homeownership and building up a principal line of equity.

Non-renewal laws, however, prove self-defeating when it comes to providing Texans cheap and easy access to homeowners insurance—for several reasons.

Higher Costs

First and foremost, not permitting insurers to engage in market corrections increases the cost of insurance policies and contributes to the elevated rates Texans pay for homeowners insurance. When policyholders take a disproportionate amount of claims money as compared to their premiums, they unsettle an insurer's risk calculation, turning a stable risk pool into a toxic asset that reduces the company's capital and could jeopardize its ability meet its obligations to other customers. Since an insurance company has a responsibility to stay solvent, and since Texas' non-renewal law often prevents the company from holding specific policyholders accountable for their overuse of the claims process, the law makes an insurance company recoup its losses by raising rates overall or by reducing coverage. The first increases the cost of insurance directly as consumers pay a higher premium; the second increases the costs indirectly as companies have little incentive to reduce prices when operating in a market with few competitors. Either way, Texas consumers pay for the extra risk that insurance companies are compelled to take on.

Encourages Risky Behavior

What's more, non-renewal laws eliminate the price signals that would typically discourage policyholders from misusing the claims process, which only intensifies the mischief high-claim policies have on insurance prices. In a competitive market, prices do more than provide compensation. They also convey information and encourage good behavior (Lehrer 2011, p. 4). Consumers pull back from activities which increase the costs of the product they want, and insurers stop business practices that dissuade consumers from employing their services. These price signals are especially vital in an insurance market, where the structure and makeup of policies depend heavily on how much risk exposure a customer's actions have (Ben Shahar and Logue 2012, p. 206-207).

Non-renewal laws, however, suppress these price signals by sheltering select consumers from the market consequences of their choices (Brannan 2011). Insurers cannot charge the policyholder according to their actual risk, and consumers do not receive notice that these choices carry heightened costs.

They, therefore, continue to make riskier choices, such as failing to make necessary repairs (Peacock 2013, p. 2). The intervention gives consumers the incentive and the opportunity to socialize the costs of risky behavior.

Penalizes Prudent Policyholders

In addition, restrictions on non-renewals and surcharges breed a culture where homeowners continuously expect to be bailed out when their gambles go awry—all at the expense of their more prudent neighbors. Non-renewal laws prevent insurers from holding risk-prone policyholders accountable, which means that policyholders, regardless of whether or not they contributed to the heightened risk, end up paying higher rates as insurers attempt to recoup otherwise avoidable losses. Prudent policyholders are forced to subsidize the reckless behavior of others, and non-renewal laws wind up acting like a wealth redistribution scheme.

Reduces Consumer Choice

Non-renewal laws also could reduce consumer choice, making it harder for Texans to find suitable insurance. High-claim policies cause insurers to become overexposed to risk. One way to fix that over exposure is to raise insurance premiums; another way is to drop coverage altogether. If an insurer cannot self-correct its overexposure within the market, and if raising rates will not cover the insurer's liabilities, then an insurer could decide to stop offering coverage to a region altogether. The increased risk also could dissuade the insurer from entering the market. This will not only keep insurers from participating, but the ensuing contraction of the market will wear away at the willingness of insurers to offer specialized risk pools and customized services since companies have little reason to innovate when they have a captive consumer base.

Less Consumer Protection

Finally, the resulting curtailed market offers consumers less protection from bad business practices. Texas' non-renewal regulations add another layer of risk and uncertainty for companies that wish to sell homeowners insurance. This deters new entrants from entering the market and could push existing providers out because they cannot readjust their risk pools, depriving consumers of their greatest protection against unfriendly practices, choice. The competitive market, and the choices that ensue, represent the best consumer-protection measure available because, in a competitive market, consumers can punish companies that set prices too high or engage in deceptive or unfriendly behaviors simply by switching to another producer and/or provider. Competition empowers consumers. Thus, if Texas non-renewal law was to drive companies out of the insurance market or deter their entry into the market, then the non-renewal law would divest consumers of their greatest leverage.

The West Virginia Experience

The experience of West Virginia offers a good example on how non-renewal laws curb consumer choice and how the easing of these restrictions can lead to expanded access. In 2005, West Virginia made legislative changes to its non-renewal laws, allowing qualifying companies to "non-renew a property insurance policy for any reason that is consistent with its underwriting standards" so long as the resulting non-renewals did not exceed one percent of the total number policies the insurer had in force in the state (West Virginia Code, Sect. 33-17 A-4). Once enacted, 12 companies representing approximately 33 percent of the market share elected to pursue this new non-renewal method; the remaining 164 companies elected to base their non-renewal decisions on the traditional statutory standard (West Virginia Offices of the Insurance Commissioner (WVOIC) 2010, p. 9).

An assessment made by the West Virginia Office of the Insurance Commissioner found that the legislation led to marked improvements in the homeowners insurance market, including an increase in competition, a decline in homeowners reliance on the residual market, and a general decrease in the percentage of policies being non-renewed (WVOIC 2010, p. 10-15). Specifically, the assessment found that not only did the actual number of non-renewal remain well below the permissible 1 percent limit, but that companies who elected to use underwriting standards had six-times fewer non-renewals than the companies who relied on the old statutory enumerated reasons (WVOIC 2010, p. 15). The ability of insurers to use actuarial principles enabled them to make efficient and tailored decisions so that fewer non-renewals were necessary to balance their risk pools.

Moreover, the relaxed non-renewal laws were shown to have a positive impact on the ability of West Virginians to obtain insurance in the voluntary market. The assessment noted that while a slight decline in the number of residual market policies—the state-sponsored option for homeowners unable to secure insurance—already occurred before the legislation was enacted, that decline was shown to have steepened dramatically after the 2005 reforms (WVOIC 2010, p. 12). The assessment concluded that the trend was "a very favorable indicator" that the legislative changes made private insurance more readily available and gave homeowners more options (WVOIC 2010, p. 12).

Recommendations for Improvement

A healthy competitive market will foster efficient pricing and innovation that, in the long run, will result in specialized risk pools that offer consumers the fairest and lowest price based on their own behaviors and not the reckless practices of others. That competition, however, can only occur if Texas law grants insurers the freedom to make business decisions based on actuarial principles rather than the preferences of regulators and special interests (Peacock 2013, p. 1-2).

Texas' requirement that insurance companies retain what are essentially toxic assets contributes to the high price Texans pay for homeowners insurance. The rule disrupts what would otherwise be the market's natural self-correction, artificially exposing insurance companies to risk and arranging conditions so that insurers are compelled to raise rates or drop their coverage entirely. This, in turn, inflates insurance prices, reduces consumer choice, and ultimately dispossesses consumers of their greatest protection, the ability to move their business to a competitor. Loosening the restriction, therefore, exemplifies the type of targeted reform that would free up the market to greater competition and relieve the financial burden placed on Texas consumers without necessitating a restructuring of insurance regulations more generally.

With this in mind, we recommend the following:

Amend Sec. 551.107(c), Texas Insurance Code, to allow insurers to assess a premium surcharge for any number of claims so long as the amount is based on sound actuarial principles.

The current system of limiting surcharges hinders the operation of the competitive market by preventing insurers from self-correcting any overexposure, and it produces business practices that are unfavorable to consumers since insurers are pushed either towards raising rates with no complementary improvement in services or towards dropping coverage altogether. Amending the circumstances in which insurers are able to add a premium surcharge would provide the market with much needed flexibility, giving insurers sensible options other than penalizing customers for the risky, and even fraudulent, behavior of others. It would allow insurers to rebalance their risk pool while preserving the quality and quantity of services offered to consumers, if not engendering their expansion as robust competition encourages insurers to innovate.

Amend Section 551.107(c), Texas Insurance Code, to explicitly allow insurers to stipulate an increase in a policy's deductible before agreeing to a renewal.

This would offer insurers another less extreme option to tweak their risk pools without affecting the services of the rest of their customer-base. At the same time, it would introduce additional price signals that would inform consumers of the actual costs of their risky behavior, inducing them to reduce their own risk exposure without further action on behalf of the insurer or the government.

Amend Section 551.107(d), Texas Insurance Code, to eliminate the requirement that a policyholder (c) must file multiple claims before an insurer may non-renew a policy.

As with reforms proposed above, reducing the number of necessary claims would introduce much needed flexibility into the market, along with ensuring that the costs of risky decisions in the location and maintenance of a policyholder's property are borne by that policyholder and not Texans more generally. The change would reorient the insurance market towards actuarial calculations, which promotes competition and ensures that consumers pay for coverage that reflects their own their risks rather than the risks of others.

Conclusion

The proposed changes will expand the number of Texans able to afford and acquire homeowners insurance. Our recommendations permit insurers to discontinue or modify their most expensive policies at the end of their contractual period, enabling insurers to keep insurance rates at a level that is both manageable and accessible to Texas homeowners. Insurers will no longer be obliged to absorb the loss of essentially toxic insurance policies and, therefore, will not be pressured into passing along those costs to their other customers. Prices will reflect a lower risk exposure, opening up the homeowners market to Texans of more modest means.

In addition, these three changes would give insurers the needed liberty to develop specialized services and risk pools for high risk properties, thereby offering consumers more coverage, more options, and more personalized prices than the most well intended regulation ever could. Insurers will have more alternatives when responding to a change in circumstances, and will not be bound to continue offering policies at a loss. The reforms thus furnish insurance providers the freedom to research and tailor their own risk exposure, developing specialized markets with coverage and prices that match a customer's needs and not the preferences of special interests. Insurers will not fear that law would force them to continue a failed service or innovation and, as a result, would be more willing to create customized policy pools for higher risk homeowners.

Not only would this help improve access to insurance even for Texans in high risk areas, it would offer consumers more market choices and, therefore, more control over the type of coverage they receive. Hence, the new rules would empower consumers since consumers would retain the ability to decline the new conditions and elect to move their business elsewhere—a power that only exists in a free, competitive market. Consumers in essence would become the final arbitrator of whether an insurance policy is worth the extra charge, and they, not the government, would become final judge of whether their chosen lifestyle and behaviors are worth the costs of a high risk insurance policy. Consumers benefit from more choices, and the Texas economy benefits from the efficient and cost-effective allocation of resources as insurance rates begin to follow demand.

If lawmakers truly wish to spread the benefits of homeowners insurance, then they would be better served by eliminating those regulations that attempt to replace an insurer's actuarial assessment than they would be by imposing restrictions that socialize the costs of a chosen constituency's lifestyle. Texas' non-renewal laws represent a good place to start.

Like most of the government's interventions in the market, Texas' proscription on non-renewals merely shifts the costs away to an unseen party—in this case, the average Texas consumer, whom the law was said to protect. In addition, it paves the way for a parade of unintended consequences including, increased costs, greater difficulty in finding insurance, fewer market choices, and less protection from bad business practices. It, therefore, embodies the type of targeted reform in which lawmakers could see appreciable results in making homeowners insurance fairer, more affordable, and more in line with the free market principles that define Texas. ✯

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