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# Shopping for a Solution

*Effective consumer protection*
*through competitive regulation of insurance rates*

by

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## EXECUTIVE SUMMARY

Government regulation of insurance rates was designed to ensure company solvency by facilitating anti-competitive practices that propped up rates. Today, however, solvency regulation is achieved through other means and the insurance marketplace has become highly competitive.

But government price fixing endures. State regulation is now used to suppress, rather than prop up, insurance rates; the purpose of regulation has shifted from promoting company solvency to establishing affordable prices for consumers. Mismatched use of government power has yielded poor results. Although price controls may initially lower consumer costs, price controls *do not* produce lower insurance rates in the long term, as are produced by competition. Furthermore, price controls greatly hinder accessibility of coverage in stressed markets -- like Texas.

New Jersey, where automobile insurance rates, like Texas' homeowners, are the nation's highest, destroyed its marketplace by using price controls and rate rollbacks instead of competition to protect its consumers. Prevented from matching price with expected risk, many companies walled off their capital exposure in New Jersey from their national surplus by forming single state subsidiaries. Now these companies are leaving the state to avoid insolvency.

In contrast, when South Carolina shifted regulation of its troubled marketplace from severe government price controls to market-based solutions, capital rushed to the state and the number of carriers doubled in just two years. Texas policymakers should follow South Carolina's example by committing to and codifying competitively regulated insurance rates.

Because market freedom in Texas exists by loophole, not by choice, insurance companies have not met consumers' demand by aggressively committing capital. Companies believe that policymakers are more likely to subject their capital investments to government capture than they are to embrace the accidentally competitive climate created by the Lloyds market. Fearing insolvency, the national carriers are carefully selling insurance in Texas through single-state subsidiaries, protecting their national surplus from a dangerous and unpredictable market and preparing their withdrawal from Texas.

Coverage will dry up for Texans unless the legislature stimulates, rather than contracts, the market by enticing capital back to the market and enabling the law of supply and demand to work.

What can the Texas Legislature do to ensure accessible and affordable insurance?

- Abolish mandated forms. Subject forms to file and use review to ensure compliance with reasonable standards of fair competition. This will allow

consumers to shop for the coverage they need and can afford.

- Allow supply and demand and state and federal antitrust laws to regulate the insurance marketplace as they do throughout the economy.

- Repeal the benchmark system of rate regulation.

- Require the state insurance department to monitor the marketplace and report regularly back to the legislature regarding the level of competition to ensure that competition is effectively regulating the market.

- If the market is not sufficiently competitive, as determined by a traditional tool such as the Herfindahl/Hirschman Index, authorize file and use regulation of rates after a reasonable period of review (one year recommended).

- Direct state resources toward necessary vigorous regulation of solvency, market conduct, consumer complaints, and form review, where consumers need government protection, instead of toward rate review where consumers can protect themselves.

Insurance, though considered of great social importance and a public good, is sold by private companies in the United States. Regulation of this marketplace must seek to complement rather than distort the laws of supply and demand.

# I. INTRODUCTION

The marketplace for personal auto and homeowners insurance in the United States is highly competitive. Hundreds of companies aggressively court customers through television, radio, print, billboards, direct mail, and Internet solicitations. Consumers receive and compare rate quotes by meeting with agents, dialing toll-free numbers, and using Internet search engines. Yet, unlike other competitively marketed products, insurance is commonly subject to price controls in the United States and, as such, Texas policymakers are considering instituting heavy government rate regulation to combat the current turmoil in their homeowners marketplace.

Although government price controls are a politically appealing response to Texas consumers' pain, state rate regulation was not designed nor intended to produce affordable and available coverage. In practice, government rate regulation does not yield lower prices than competition, but it does reduce product availability by impairing capital investment. By contrast, market competition, by producing reasonable rates and full availability, effectively protects consumers of insurance just as it does with other products.

Texas' supply of insurance is withering and failing to meet demand. Heavy rate regulation will only exacerbate this problem. The legislature can best protect vulnerable consumers by affirmatively committing to competitive rate regulation and loosening mandated form requirements, thus stimulating capital investment and preventing the looming exodus of sellers from the Texas marketplace.

# II. RATE REGULATION IN THE INSURANCE MARKETPLACE

## A. THE HISTORICAL NEED AND BASIS FOR COLLUSION

Government regulation of insurance rates was designed to ensure price adequacy, not affordability. Many states established rate regulation in the early 1900s to facilitate pricing cooperation between insurance companies. Competition had previously harmed consumers because sellers underpriced, did not properly reserve for catastrophic losses, and were highly prone to insolvency. At different points in the 1800s, fires in New York, Chicago, and Boston bankrupted a majority of the companies doing business in those locations.[1] As a result, the "fire insurance industry began to deal with the problem of inadequate rates … by establishing local associations to control price competition."[2] Following more disastrous insolvencies caused by the San Francisco earthquake of 1906, policymakers endorsed these cooperative practices by criticizing competition in rates, strongly supporting rating bureaus, and recommending state regulation of the

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[1] Stephen P. D'Arcy, *Insurance Price Deregulation: The Illinois Experience* at 250; in Deregulating Property-Liability Insurance: Restoring Competition and Increasing Market Efficiency, J. David Cummins editor, AEI-Brookings 2002. ("After the Chicago and Boston fires of the 1870s, approximately 75 percent of the country's fire insurers went bankrupt.")

[2] Id. ("The objective of these organizations was to establish rates within a region that would provide for an adequate return, protect insurers from ruinous competition, and reduce the risk of insurer insolvencies.")

resulting, non-competitive prices.[3] By ensuring that rates would be high enough to support losses, rate regulation provided a "sophisticated solution to a very complicated problem. Uncontrolled competition had recurrently proved disastrous to policy holders; the latter had much at stake in the adequacy of premiums."[4] Thus, the sole purpose of and end to be gained by government rate regulation was carrier solvency, not product affordability.

**B. THE CONSTITUTIONALITY OF RATE REGULATION**

Government regulation of insurance rates passed Supreme Court scrutiny in 1914 with a bare majority of five votes.[5] The Court's reasoning reveals that the legitimacy of government price controls is based on the obsolete assumption that the insurance marketplace is anti-competitive and monopolistic.

In German Alliance v. Lewis, the Court evaluated the plaintiff insurance company's argument that government regulation of insurance rates "is a taking of private property for a public use."[6] The Court recognized solvency as the essential goal of insurance regulation. "How necessary their solvency is, is manifest."[7] The Court held that, because insurance "is ... essentially different from ordinary commercial transactions" and "of the greatest public concern,"[8] government regulation of insurance rates was constitutional. Central to this ruling was the Court's explicit finding that the anti-competitive rating combines used by insurance companies justified the rare use of price controls.

> We may venture to observe that the price of insurance is not fixed over the counters of the companies by what Adam Smith calls the higgling of the market, but formed in the councils of the underwriters, promulgated in schedules of practically controlling constancy which the applicant for insurance is powerless to oppose and which, therefore, has led to the assertion that the business of insurance is of monopolistic character and that "it is illusory to speak of a liberty of contract."[9]

The Lewis Court's opinion was deeply rooted in the insurance market of its day. Although a modern court would not overturn the settled result of Lewis, policymakers should understand that the key premise supporting the constitutionality of insurance

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[3] Id. at 251. ("The National Convention of Insurance Commissioners (NCIC) came out with similar findings in 1914, even proposing that membership in rating bureaus be mandatory. This focus on insurance solvency and support for the anticompetitive behavior of rating bureaus then set the stage for the next development in insurance regulation…. By 1944 eighteen states regulated fire insurance rates.")

[4] Spencer L. Kimball and Ronald N. Boyce, *The Adequacy of State Insurance Rate Regulation: The McCarran-Ferguson Act in Historical Perspective*, 56 Mich. L. Rev. 545, 551 (1957-1958).

[5] German Alliance Insurance Company v. Lewis, 233 U.S. 389 (1914); the vote was 5-3 with one justice not participating in the decision.

[6] Id. at 405.

[7] Id. at 414.

[8] Id. at 414-15.

[9] Id. at 416-17.

price controls -- that the market was "monopolistic" and non-competitive and thus could not regulate itself -- no longer holds.

## C. THE BUREAU SYSTEM THRIVES AND THEN BECOMES OBSOLETE

Prior to World War II, many states enacted rate regulatory statutes, "usually authorizing the formation of private rating bureaus but controlling their practices."[10] Federal antitrust laws did not apply since the Supreme Court had held in 1868 that insurance was not interstate commerce.[11] Some insurers exploited this loophole, using boycott, intimidation, and other extreme anti-competitive measures to enforce fixed premium rates until the Justice Department indicted the vast Southeast Underwriters combination under the Sherman Act. The Supreme Court sustained the indictment by reversing itself and holding that insurance was interstate commerce.[12] By subjecting insurance to federal oversight, the Court cast doubt on the validity of state regulatory statutes, but Congress quickly passed the McCarran-Ferguson Act, delegating insurance regulation to the states and establishing "reverse preemption" whereby state insurance law trumps federal law unless the federal law is specific to insurance. McCarran itself includes the first such federal insurance law: a limited antitrust exemption for insurance companies, from which modern rate regulation has sprung.

McCarran directs that the Sherman Act, the Clayton Act, and the Federal Trade Commission Act not apply "to the business of insurance to the extent that such business is not regulated by State Law," except that the Sherman Act applies at all times to "any agreement … or act of boycott, coercion, or intimidation."[13] In order to protect solvency, the states nullified the antitrust laws by occupying the field with statutes that permitted anti-competitive practices and regulated the resulting rates.

> These bills required "prior approval" and applied to all insurers. This conservative requirement assured continuation of bureau practices unfettered by federal statutes…. "The effect of [McCarran-Ferguson] … was to lodge regulation of this interstate business in the states and to make these concerted practices legal, providing … the regulation of rates had to be 'affirmative.'" … [I]nsurers that remained committed to maintaining bureau rates used the prior approval requirement as a fulcrum for limiting competition.[14]

Following McCarran, competition was stifled by "judicial and regulatory activity, the purpose of which was to inhibit the use of non-bureau rates,"[15] as both states and bureau companies successfully challenged the filings of independent companies for being inadequate.

The days of common ratemaking are long past, however. Beginning in the 1960s, the insurance marketplace was transformed by competition. The National Association of

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[10] Kimball at 551.
[11] See Paul v. Virginia., 8 Wall. 168 (1868).
[12] U.S. v. South-Eastern Underwriters Assn., 322 U.S. 533 (1944).
[13] 15 USC 1011-15.
[14] Id. at 195-96.
[15] Id. at 197.

Insurance Commissioners (NAIC) recommended that there be "vigorous lawful competition as to … rates" and a Congressional committee "clearly affirmed that competition should be the prime regulator of insurance as it was in other industries."[16] Independent companies like Allstate and State Farm set their own rates and grew in stature and market share[17] until "the concept of making rates in concert was discontinued in the 1970s."[18] The result of these changes is an "intensively competitive"[19] personal lines marketplace.

Significant improvements in solvency practices facilitated the development of competition by eliminating the need for artificially propped-up rates. Advances in actuarial science and more sophisticated reserving methods combined with a host of regulatory measures[20] to alleviate the very problem -- mass insolvencies due to severe mismanagement and underpricing -- that rate regulation was created to solve. "Strengthened financial regulation assisted in increasing the public's confidence in the industry to the extent that making and maintaining rates in concert could no longer be rationalized."[21]

Rate regulation was designed as a means to an end. The end was the ultimate consumer protection: company solvency. The means became an antitrust exemption which for years stifled price competition. McCarran, a legislative quick fix, was grounded in the long-obsolete marketplace of the 1940s. The unusual characteristics of the insurance marketplace which justified the highly irregular practice of government price fixing -- the monopolistic conditions observed by the Supreme Court in 1914 and tacitly encouraged by Congress in 1945 -- were long ago replaced by what the Supreme Court called the "higgling of the market."[22]

## D. THE FAILURE OF MODERN GOVERNMENT RATE REGULATION

Without its value as a solvency tool, rate regulation's use has changed. There remain many "prior approval" states where rates cannot be used without the consent of the government. These laws are now justified not as solvency tools but as politically necessary measures to make insurance affordable for consumers. Many other states have file and use regimes where rates can be used unless and until they are challenged by the state. One state, Illinois, has no rating law. In between are states which have

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[16] Id. at 198.

[17] "The auto insurance market began to change dramatically in the 1950s when independent insurers such as State Farm and Allstate began more aggressive price competition." J. David Cummins, *Property-Liability Insurance Price Deregulation: The Last Bastion?* at 9 in Deregulating Property-Liability Insurance: Restoring Competition and Increasing Market Efficiency, J. David Cummins editor, AEI-Brookings 2002.

[18] Tim Wagner, *Insurance Rating Bureaus*, 19 Journal of Insurance Regulation 189, 200 (2000).

[19] Cummins at 4.

[20] Such as the National Association of Insurance Commissioners (NAIC) Holding Company Model Act (1969); the NAIC P&C Insurance Guaranty Fund Model Law (1969); the NAIC Early Warning System (1972); the implementation of CPA audit requirements; the creation of the Insurance Regulatory Information System (IRIS); publication of statutory accounting manuals; the NAIC accreditation program; and adoption of NAIC risk based capital standards (1993).

[21] Wagner at 202.

[22] Lewis at 416.

prior approval or file and use laws but which in practice do very little regulating of rates.[23]

Numerous studies have demonstrated that government rate regulation does not deliver the promised benefits of decreased costs and increased availability.[24] Instead, "on average, prior approval regulation had little or no effect on the relationship between rate levels and claim costs over time."[25] Because government price controls are anathema to otherwise competitive environments like today's insurance marketplace, decades of experience demonstrate "an inability of rate regulation to reduce average rates materially and persistently in competitively structured markets without significantly reducing product quality or ultimately causing widespread exit by insurers."[26] Government rate regulation, which is no longer used for the type of consumer protection for which it was designed, instead harms consumers by "reduc[ing] coverage availability and increas[ing] volatility for both insurers and consumers," forcing more applicants into residual markets.[27]

## III. THE ESTABLISHED SUCCESS OF OPEN COMPETITION

### A. HOW COMPETITION PROTECTS ILLINOIS CONSUMERS

Illinois, whose insurance code has no language prohibiting inadequate, excessive, or unfairly discriminatory rates, has achieved a thriving marketplace regulated by empowered, well-protected consumers. Since 1970, the law of supply and demand has been the ultimate arbiter of fair prices in Illinois.[28] Support for open competition from policymakers is oft-expressed and affirmative, and is enshrined in statute.[29] Since it is a large state with a complex marketplace, including urban markets and varied and

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[23] See Scott E. Harrington, *Effects of Prior Approval Rate Regulation of Auto Insurance*, at 290 and at Table 7-1 in Deregulating Property-Liability Insurance: Restoring Competition and Increasing Market Efficiency, J. David Cummins editor, AEI-Brookings 2002. ("A state is classified as having a competitive rating law if it permitted file-and-use, use-and-file, filing only, file-and-use or use-and-file in a 'competitive' market, or had flex rating with a large flex band.") See also D'Arcy at 259. ("One problem with studies on the effect of rate regulation is the determination of what, in fact, constitutes rate regulation…. [I]n practice there are considerable differences in the application of a rating law, with some prior approval states routinely approving all filings and some file-and-use states that frequently disapprove rate filings, forcing companies to refile new rates until the insurance department finally accepts them.") Texas' benchmarking system fits in between; its flex rating mixes prior approval with file and use, but it has been replaced in large part by competitive rating in the Lloyds market.

[24] See Id.; R. Saba, *An Alternative Theory of the Regulation of Automobile Insurance*, 44 Southern Economic Journal at 469-76 (1978); Scott E. Harrington, *A Note on the Impact of Auto Insurance Rate Regulation*, 69 Review of Economics and Statistics at 166-70 (1987); and Henry Grabowski, W. Kip Viscusi, and William N. Evans, *Price and Availability Tradeoffs of Automobile Insurance Regulation*, 56 Journal of Risk and Insurance 275-99 (1989).

[25] Harrington, *Effects of Prior Approval Rate Regulation of Auto Insurance*, at 309.

[26] Id.

[27] Id.

[28] See D'Arcy at 267. ("However, rates are not subject to approval and cannot be disapproved, leaving insurers free to charge whatever rates market conditions dictate.")

[29] 215 ILCS 5/1201 ("It is the express intent of this article to permit and encourage competition between companies on a sound financial basis to the fullest extent possible and to establish a mechanism to ensure the provision of adequate insurance at reasonable rates to the citizens of this state.")

substantial weather challenges, Illinois's thirty-year experience establishes a relevant point of comparison for other states, including Texas.

Competition has produced very healthy auto and homeowners markets for Illinois consumers. Coverage is available and affordable: the number of companies actively writing business in Illinois is the highest in the nation[30] and rates are at or lower than the national average.[31] Statistical analyses of the market demonstrate its competitiveness; the Herfindahl/Hirschman Index for the Illinois auto and homeowners markets indicates broad penetration by many sellers in a non-concentrated marketplace.[32] Availability concerns are negligible; only a tiny proportion of consumers are forced to obtain coverage through residual market plans.[33] Furthermore, the percentage of uninsured motorists appears to be lower in Illinois than nationally.[34]

Like Texas, Illinois homeowners face perils of great severity and variety, but Illinois has been able to sustain its healthy market despite significant exposure to catastrophic and other losses. In fact, between 1996 and 2001, Illinois had significantly higher homeowners incurred loss ratios than Texas.[35] During that time, eight of the ten highest average loss ratios were recorded in mid-western states,[36] whose perils differ markedly from Texas' but apparently are no less significant.

The absence of affirmative state rate regulation does not shortchange Illinois consumers, who receive substantial and meaningful protections under statute and regulatory practice. Rates in Illinois are regulated -- by the law of supply and demand instead of by government. Since the Illinois marketplace is competitive, it is controlled by the most exacting regulator known to the economy. To ensure that the market is working, the Illinois Cost Containment Act requires the department of insurance to verify that the market is competitive. The department collects company data and analyzes that information with tools like the Herfindahl/Hirschman Index in order to report annually to the legislature "what it deems to be the most appropriate and comprehensive cost containment system for the State."[37] Competition is further guaranteed by federal and state antitrust laws; since the state does not regulate rates, McCarran-Ferguson's federal antitrust exemption does not apply. And most importantly, the department affirmatively and aggressively regulates the aspects of the insurance business that need such government oversight. Forms are filed, scrutinized for adherence to applicable laws, and challenged if they are non-compliant. The department's consumer complaint division investigates thousands of inquiries every

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[30] AMBest Executive Data Service.

[31] Illinois' auto rates are 27th highest and homeowners are 39th. Insurance Information Institute, average expenditures statistics, 1996-2000.

[32] See *Annual Report to the Illinois General Assembly on Insurance Cost Containment*, at 7, 8, 13, Illinois Department of Insurance, April 15, 2002.

[33] Only .03 percent of the market is in the automobile assigned risk plan and .22 percent in the homeowners assigned risk plan. See Id. at 21.

[34] D'Arcy at 276.

[35] Illinois' average ratio was 83.6 and Texas' 68.7. National Association of Insurance Commissioners Profitability Reports; average of figures in Homeowners Multiple Peril line, 1996-2001.

[36] Id.; American Insurance Association chart of resulting data.

[37] 215 ILCS 5/1202.

year. Solvency and market conduct are aggressively reviewed. The department's expertise is renowned: Illinois is chiefly responsible for many of the model laws and practices used in the crown jewel of the state-based, national regulatory system, the National Association of Insurance Commissioners' state accreditation program.

Illinois, which consistently receives high ratings from consumer groups in national surveys of insurance departments, [38] employs a system of regulation that closely tracks the thoughtful dissent in German Alliance v. Lewis. In that dissent, Justice Lamar opposed government regulation of insurance prices based on "a distinction between a public interest -- justifying regulation -- and a public use -- justifying price fixing. 'Public interest and public use are not synonymous.'"[39] Distinguishing between rate statutes and regulatory statutes, Lamar explained that consumers cannot negotiate as equals with companies in some aspects of their insurance transactions.

> The public had no means of knowing whether these corporations were solvent or not, and statutes were passed to require a publication of the financial condition. The policies were long and complicated, with exceptions, and qualifications, and provisos. They were often unread by the policyholder and sometimes not understood when read…. [S]tatutes were passed and can still be passed to punish combinations, pooling arrangements, and all those practices which amount to unfair competition.[40]

If government did not regulate solvency, market conduct, and forms, the insurance marketplace – and by extension much of the economy – would be ruined by a "race to the bottom." However, government regulation of rates is not necessary since consumers are used to shopping for price. "[T]he failure for more than 100 years to attempt to fix the rates of insurance is indubitable evidence of the general public and legislative conception that the business of insurance did not belong to the class whose rates could be fixed."[41] Lamar failed to carry the argument in Lewis because the 1914 insurance market had elements of a "monopolistic character,"[42] but his logic is particularly compelling now that the bureau system has been replaced by competition. Since consumers today are able to effectively shop for price, government's scarce resources should be budgeted on areas like solvency, market conduct, and forms, where consumers cannot protect themselves without active state oversight.

## B. COMPETITION HEALS SOUTH CAROLINA'S TROUBLED MARKET

The positive results from South Carolina's recent shift in private passenger auto regulation from prior approval of rates toward more market-based regulation of prices demonstrate that incentives for capital investment provide the best consumer protection in a stressed market. In 1997, South Carolina, one of "the most 'activist' prior approval

[38] See www.consumerfed.org.
[39] Lewis at 427.
[40] Id. at 423.
[41] Id. at 422.
[42] Id. at 417.

states,"[43] suffered from a significant availability crisis. In the 1980s, "suppression of both voluntary and [residual market] rates prompted some insurers to exit or retrench from the South Carolina auto insurance market."[44] Severe restrictions on pairing risk with price caused capital commitment to wane. In a healthy environment, a "reasonable flow of insurers in and out of a market facilitates competition and helps ensure an adequate supply of coverage. In a 'normal' market that is 'workably competitive,' one would expect to see a small number of insurers both entering and exiting the market over time."[45] Instead, South Carolina's pool of sellers shrunk, and the state instituted a surcharge on all drivers to subsidize the large residual market, resulting in rising premiums and an availability crisis similar to today's Texas homeowners market.[46]

South Carolina policymakers successfully stabilized their marketplace by treating their political problem as a simple economic challenge of attracting capital. The sponsor of the 1997 law that transformed the marketplace described his bill as "radical reform…. [I]t is sort of like the patient diagnosed with serious cancer…. You can't treat it with aspirin. We had a patient that was dying."[47] Rejecting further price controls, the legislature instead passed sweeping measures which increased competition.[48] By maturely subordinating the desire for immediate price reductions to the long-term benefits of stability, affordability and accessibility,[49] South Carolina policymakers committed to market solutions through both statute and rhetoric, and sellers responded by pouring back to the market. The number of insurers writing auto policies doubled; rates steadied and in many cases declined; and the residual market pool diminished rapidly.[50] South Carolina is now extending its competition-based reforms to the homeowners market, which, like Texas', faces extreme weather perils and an availability crisis. "'We have a lot of growth along the coast, but we have a shortage of insurance companies. We need to get new insurers in,' said Dean Kruger, chief casualty actuary for South Carolina's Department of Insurance."[51]

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[43] Martin F. Grace, Robert W. Klein, Richard D. Phillips, *Auto Insurance Reform: Salvation in South Carolina* at 152 in Deregulating Property-Liability Insurance: Restoring Competition and Increasing Market Efficiency, J. David Cummins editor, AEI-Brookings 2002.
[44] Id. at 158.
[45] Id. at 163.
[46] The number of carriers writing auto insurance in the state declined by approximately 20%, the concentration of the market increased by nearly 30%, and the residual market ballooned to 29% of drivers in 1998. Id. at 157-61.
[47] Jim Parker, The Post and Courier (Charleston, SC), *State's auto insurance reform will take motorists on wild ride,* Sept. 7, 1997, at A1.
[48] These included instituting a flex rating system under which increases that require regulatory approval have been liberally granted and the abolition of uniform classification systems and restrictions on territorial rates. See Grace et al at 152-156.
[49] "Whatever the case, reform is ramping up. It's akin to a driver easing into first gear today, then slamming into high from 1999 to 2003, and -- if all goes to plan -- hitting cruise control by the year 2005…. Even insurance reform supporters agree the changes won't result in a wholesale rate reduction, but they will restore a competitive marketplace." Parker at A1.
[50] Grace et al at 193.
[51] Michele Kay, Austin American Statesman, *Will Texas find safe haven in the storm? As insurance companies strive to offset huge losses, state will try to keep policies within reach of homeowners,* Feb. 2, 2003, at E1.

## IV. OVERBURDENSOME REGULATION DESTROYS NEW JERSEY'S MARKETPLACE

South Carolina healed its market by resisting the common tendency to seek consumer protection in price controls. New Jersey and Massachusetts, by contrast, have devastated their difficult markets through more and more government rate regulation, driving insurers from the marketplace, drying up capital, meeting increased demand with decreased supply, and producing dismal results for consumers.[52] New Jersey's auto market, like Texas' homeowners, has possibly the worst loss environment in the country. Texas' extreme weather conditions make it prone to severe homeowners losses, while New Jersey's densely populated roads cause relentless loss problems in the auto market.[53] Both Texas homeowners and New Jersey auto insurance rates are leading issues in gubernatorial and legislative campaigns, with candidates promising voters price reductions.

New Jersey has responded to political pressure with a series of strict regulatory statutes designed to stifle rather than promote free competition,[54] including two landmark measures following gubernatorial elections: Gov. Florio's Fair Automobile Insurance Act of 1990, which established a take-all-comers rule, and prevented companies from using cost pass-throughs to recoup the assessments and surtaxes they are charged to fund the assigned risk plan; and Gov. Whitman's Automobile Insurance Cost Reduction Act of 1998, which instituted cost control measures but mandated a 15% rate rollback. Insurers have been "bleeding capital"[55] since these measures were implemented, and dozens have begun withdrawing from the market,[56] creating an extraordinary availability crisis where, according to the current governor now saddled with the results of these policies, "it's no longer possible to walk into an agency and walk out with a policy."[57]

State Farm's withdrawal from New Jersey vividly demonstrates the economic consequences of using punitive cost controls to protect consumers in a struggling market. New Jersey's regulatory statutes essentially forbid companies from

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[52] This paper will hereafter focus on New Jersey's market for simplicity's sake but Massachusetts has similar pathologies. For more on Massachusetts' market, see Sharon Tennyson, Mary A. Weiss, and Laureen Regan, *Automobile Insurance Regulation: The Massachusetts Experience*, in Deregulating Property-Liability Insurance: Restoring Competition and Increasing Market Efficiency, J. David Cummins editor, AEI-Brookings 2002.

[53] See John D.Worrall, *Private Passenger Auto Insurance in New Jersey: A Three-Decade Advertisement for Reform* at 82 in Deregulating Property-Liability Insurance: Restoring Competition and Increasing Market Efficiency, J. David Cummins editor, AEI-Brookings 2002. ("It has metropolitan areas and cities that consistently rank at or near the top of the auto theft table, has been a haven for notorious fraud rings, and has had a 'Cadillac' benefit system.")

[54] See Id. at 105.

[55] Randy Diamond, The Record (Bergen County, NJ), *3rd Auto Insurer Wants to Quit N.J.; Ailing Firm Turning Away New Customers*, June 21, 2001 at A1.

[56] See Id.; Iver Peterson and Joseph B. Treaster, The New York Times, *Major Insurers May Pull Out Of New Jersey*, June 21, 2001, at B1; Randy Diamond, The Record (Bergen County, NJ), *Auto insurers' exodus from N.J. continuing*, Sept. 7, 2002, at A4; *Central Mutual is latest insurer to seek withdrawal from N.J.,* BestWire, *BestDay News Summary*, Dec. 30, 2002.

[57] Speech of Gov. James McGreevey to New Jersey Auto Agents Alliance, March 4, 2003, also referencing "the insanity of a system that forces good drivers to wait for weeks, even months, to obtain coverage … when carrier after carrier gives up on New Jersey."

meaningfully employing the most basic and necessary tools of the insurance business: selecting and pricing risk. Unable to effectively run its business, State Farm carried out its fiduciary responsibilities to its national policyholders by forming a separate company for New Jersey-only business to quarantine that state's dangerous risk. "New Jersey Indemnity was created in 1992 as a separate company from State Farm Mutual 'basically to allow us to continue to service our customers in New Jersey without putting other (State Farm) policyholders at risk.'"[58] This is rational behavior when despite "the highest average auto insurance rates in the nation, … 19 of the 50 auto insurers in the state are in financial trouble."[59] State Farm's New Jersey operations were supported not by the capital of State Farm Mutual, the parent company, but rather by State Farm Indemnity, which was far more thinly capitalized. Since, following years of disastrous results, State Farm's New Jersey premiums have not supported its New Jersey losses, State Farm Indemnity's dwindling capital has triggered heavy regulatory scrutiny. "[New Jersey Insurance Commissioner Holly] Bakke said about 96,000 customers will be dropped over the next two years because the Illinois Department of Insurance, which regulates State Farm Indemnity,[60] determined the company did not have sufficient cash to cover potential claims."[61]

The reaction of New Jersey's then-governor to State Farm's withdrawal announcement illustrates the disconnect between the politics of rate regulation and the needs of the market. "Rae Hutton, a spokeswoman for Acting Gov. Donald T. DiFrancesco, said, 'State Farm and A.I.G.[62] are worried about their bottom lines, but our bottom line is the money motorists have to pay for insurance, and we think it should be lower.'"[63] This purely political response ignored the essence of the state's economic problem. It is true that insurance is imbued with a vital public interest. Without auto insurance, New Jerseyans could not go to work, shop for groceries, or live functional lives, just as Texans without insurance could not invest in and own their own homes, a practice at the heart of American democracy. Insurance has thus been called "the glue that holds our economy together" by the most influential public official who oversees the industry.[64] Insurance is, in the words of a leading consumer advocate, "not a product at all in the classic sense of the word, it is rather the creation by consumers of

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[58] Kathy McKinney, Bloomington (Ill.) Pantagraph, *N.J. policies to be yanked; State Farm cites costly rules*, June 13, 2001, at A1.

[59] Randy Diamond, The Record (Bergen County, NJ), *Insurance plan would make rate increases easier; Governor says companies flight from state justifies turnaround*, Jan. 15, 2003, at A9.

[60] Because that company is domesticated in Illinois.

[61] Herb Jackson, The Record (Bergen County, NJ), *State Farm Pullout on hold; Insurer will cut 13% of policies*, June 26, 2002, at A1; see also Report of Examination of State Farm Indemnity Company, Illinois Department of Insurance, March 8, 2001 ("The examiners conclude that the primary reason for degeneration of the Company's results is the impact of Senate Bill 3, which … marketed a rate rollback to accompany the claim cost reduction provisions of this law. This rate reduction averaged 16.5% … for State Farm Indemnity Company, but the claim cost reduction intended by the law's provisions were not evident in the data analyzed by the examiners.")

[62] Which also announced withdrawal plans.

[63] Peterson and Treaster at B1.

[64] Rep. Michael Oxley (Ohio), quoted in Stephen Labaton, *House Votes to Shield Insurers and Limit Suits by Future Terror Victims*, New York Times, Nov. 30, 2001, at B8.

the common fund from which claims are paid."[65] But insurance is not a government program;[66] it is rather a regulated business in which the risk bearers are private corporations responsible to their ownership and policyholders. Companies must by definition "be worried about their bottom lines" or they will fail their consumers. State Farm Indemnity and other for-profit carriers cannot escape the rules of economics, which produce clear data in New Jersey that conflict with the governor's arbitrary political judgment that "the money motorists have to pay for insurance … should be lower." New Jersey's extreme grafting of social goals onto a capitalistic system has created the unusual situation where, when State Farm sought withdrawal, its competitors were unwilling or unable to seize the opportunity to obtain the market leader's customers.[67]

Government price controls have failed so thoroughly that even New Jersey's fierce politics have begun bending toward market-based solutions. Gov. James McGreevey, elected on a promise to force companies to lower rates, has recently begun advocating competitive solutions.[68] His rhetoric reflects recognition that New Jersey must create incentives for capital commitment through radically different regulatory policies:

- "Customers, simply put, do not benefit if companies confront financial difficulty and subsequently leave New Jersey."[69]
- "For too long, the auto insurance crisis has been viewed solely as an affordability issue. Every day we see new evidence that it is no longer just about affordability, it is very much about availability."[70]
- "Twenty-six carriers have left New Jersey in the past decade, including six in the past eleven months."[71]
- "In my State of the State address, I called for a market overhaul that will bring carriers and capital back to New Jersey."[72]
- "We can change the New Jersey marketplace so there are more companies and more competition and greater access and more affordable rates for good drivers."[73]

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[65] Robert J. Hunter, "Consumer Concerns Regarding the NAIC process to restructure regulation," Consumer Federation of America, June, 2000.

[66] With specific exceptions like Social Security and Medicare.

[67] See Herb Jackson, The Record (Bergen County, NJ), *State Farm pullout on hold; Insurer will cut 13% of policies,* June 26, 2002, at A1. ("If its application to leave had been approved, State Farm would have dumped all of its customers during a six-month period beginning in January 2003. Industry experts said the remaining companies in New Jersey could not have absorbed that many risks that quickly.")

[68] See Id. ("McGreevey, who as a candidate in 1997 assailed Gov. Christine Whitman over insurance rates, used the news conference to criticize the administrations of his Republican predecessors for basing decisions about insurance rates on politics instead of business."); Randy Diamond, The Record (Bergen County NJ), *Insurance plan would make rate increases easier; Governor says companies flight from state justifies turnaround*, January 15, 2003, at A9 ("It's a 180-degree turn for Governor McGreevey, who acknowledged in his State of the State address Tuesday that a new political reality is at play: New Jersey's auto insurance marketplace is in crisis as insurers flee the state, complaining that rate-increase requests have been refused or delayed.")

[69] Jackson at A1.

[70] Gov. James McGreevey, speech to New Jersey Auto Agents Alliance, March 4, 2003.

[71] Id.

[72] Id.

[73] Id.

New Jersey has the country's highest auto insurance claims costs. Under some conceptions of public policy, it is unfair that New Jersey drivers must pay the resulting highest premiums in the nation. However, auto insurance in this country is not completely socialized like Medicare; its risk is borne by private businesses which must correlate premiums to expected losses. New Jersey's experience shows that consumers are harmed when government regulates stressed markets without recognizing and facilitating their most basic characteristics.

## V. TEXAS' CHOICE

Although Texas has, in practice, virtually no government regulation of homeowners rates, its regulatory system is not competition-based. Form regulation is still stifling and Texas has come to competition in rates unintentionally and essentially by accident. The gradual migration of 95% of the market to the alternative Lloyds system represents the triumph of a loophole, not the creation of incentives for capital investment. As in New Jersey, the single-state Lloyds companies, despite their affiliation with large national companies, will withdraw as Texas premiums become demonstrably unable to support Texas losses.

### A. THE DEVELOPING CRISIS AND CALLS FOR GOVERNMENT REGULATION

The supplanting of Texas' official benchmarking system by the Lloyds system, a development much lamented in the press,[74] produced a market for years where coverage was both affordable and accessible. Even current critics of the Lloyds market concede that the absence of government rate regulation benefited consumers. "[E]verything was working pretty well. Our unregulated rates were in many cases lower than the benchmark. Competition was a regulator and everything was working fine."[75]

Policymakers did not object as the Lloyds market grew because, since rates stayed down, the benefits to consumers were obvious. However, political reactions to consumers' understandable sensitivity to rates have left the Lloyds system as a target for blame in a hard market. "But the problem you have and what we discovered was that once the market ceases to be the regulator, which it did about a year and a half ago, then the sky's the limit."[76] The market has not ceased being a regulator, however; it is reacting as it must to uncertain and extreme conditions, caused by:

- A precipitous loss in investment income which necessitated a greater reliance on premiums to support risk.

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[74] See Editorial Board, San Antonio Express-News, *Insurance problems difficult to address; Lawmakers seeking to tackle insurance industry reform face a complex balancing act*, December 8, 2002. ("The benchmark method worked relatively well, until the industry found a way to exploit a loophole."); Editorial Board, The Dallas Morning News, *Insurance Meltdown; Legislature must tackle this issue*, August 25, 2002. ("A loophole in the system, however, allows insurers to avoid the benchmark system entirely…. Taking advantage of that gap, insurers now sell more than 95 percent of homeowners' policies through subsidiaries that aren't subject to any state price supervision. This distortion must end.")

[75] Austin American-Statesman, *Nature had role in insurance crisis, legislator says*, Dec. 8, 2002, Interview with State Rep. John Smithee.

[76] Id.

- A spike in costs due to increased severity of claims and higher payouts.
- The extraordinary mold peril, which because of its unpredictable nature, has frustrated actuarial methods.

Because Texas does not officially embrace competition, and because insurers perceive that cost controls are the likely political outcome, the market has rationally regulated sellers by forcing them to limit capital risk-taking in order to avoid insolvency.

Those who are suspicious of competitive solutions acknowledge the enormous exposure now faced by carriers in Texas,[77] but they argue that only government rate regulation can protect consumers from Texas' peculiar market conditions. One such perceived problem is that a shrinking supply, caused by disincentives to invest, distorts the market.

> Nobody was willing to come in and write (policies) and take any more risk because of all these factors, particularly the economy. So we got into what was a pure seller's market. They could basically charge whatever they wanted to charge.[78]

Another related complaint is that a relatively inelastic demand function somehow moots competition.

> In an ideal free market, insurers would compete for customers using price and service as inducements. Market competition works best when the products for sale aren't necessities. That's not the case with insurance. Mortgagers require that homeowners buy insurance. For that reason, state officials have an obligation to assure that the product is fair, available and affordable.[79]

These observers accurately note that poor incentives have dried up the supply of homeowners insurance and that buyers still must have the product. However, these features of the marketplace should not be considered indictments of competition but rather challenges to be met by following the traditional rules of capitalism. Neither tight markets nor inelastic demand produce price controls of necessities like gasoline, food and shelter. Yet because of insurance's unique history, government rate regulation remains a standard response to price increases – even though the threat of such creates a self-fulfilling prophecy, distorting the market by scaring off capital and withering availability.

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[77] See Id. ("[W]e had two or three bad weather years in a row…. And on top of that we had the mold situation…. On top of that, you had what's generally around the country a bad insurance economy…. Right now, we're looking at one unprecedented condition: That is, interest rates are at historic lows, and secondly, we were just coming off a down stock market.") See also Editorial Board, Austin American-Statesman, *78th Texas Legislative Sessions; New cooks, same old menu; INSURANCE: State must rein in out-of-control industry*, Jan. 1, 2003 ("The insurers' problems were real. Homeowners' claims amounted to $1.3 billion in 1999; $2.2 billion in 2000 and $2.9 billion in 2001. And even as claims shot up, investment income on premiums for most insurers -- for some, the difference between a profitable year and a loser -- was falling, thanks to a generally declining economy.")

[78] American-Statesman Interview with Rep. Smithee.

[79] Dallas Morning News editorial, 8-25-02.

## B. FRAMING THE QUESTION

Price control advocates in Texas assert the premise that competition has been tried and has failed, and must be replaced by government supervision. However, the Lloyds market has not created true competition. Although it has benefited consumers by allowing price-shopping, several characteristics of the Texas market have prevented it from developing the effective capital incentives found in a truly competitive market. Texas' official policy is still the benchmarking system. Upon a hard and troubled market, legislators have aggressively moved to end competition in the Lloyds system. Accordingly, sellers do not approach Texas as they do Illinois or South Carolina, where they know from both the letter of statute and the color of public debate that capital investments will grow without government intervention, even in tough times. Furthermore, since the Lloyds market was not intended to and does not allow national companies to sell insurance in Texas, large, highly-capitalized companies do their business in Texas through single-state subsidiaries -- creating a New Jersey dynamic where the market has comparatively limited access to capital and companies' business plans are heavily influenced by withdrawal scenarios. Compounding these problems, the extreme regulation of forms in both the benchmark and Lloyds systems[80] exacerbates the disincentives for capital investment described above. Forms are carefully regulated in other states through file and use review without the stifling effect of a required contract. Consumers use choice in forms to blunt the increased rates and tighter underwriting standards of hard markets by shopping carefully for the types and levels of coverage they need at prices they can afford.

Since sellers do not treat the Lloyds market as truly competitive, they have not aggressively met demand during the recent crisis. As a result, the harm to consumers from Farmers' withdrawal from Texas (before it was reversed) mirrored that caused by State Farm Indemnity's pullout from New Jersey, with "a lot of Texans [left] scrambling to find replacement coverage in [an already tight] market."[81]

## C. POLICY RECOMMENDATIONS FOR TEXAS

New Jersey's and South Carolina's recent experiences demonstrate that incentives (or disincentives) for capital investment determine the fate of troubled marketplaces. Texas' position today is analogous to New Jersey's before its 1998 rate rollback: it has the costliest market in the country; it has just emerged from an election in which the question of insurance rates was a major issue; and the national companies selling insurance in the state have walled off and limited their exposure through single-state subsidiaries. Furthermore, Texas faces two additional problems that New Jersey did not -- the hard market caused nationally by the plunging of investment income and the spike in claims severity, and the rigid form regulation which leaves the market less able to adapt to these hard conditions.

The policies legislators choose to protect Texas consumers must be designed to attract rather than repel capital. Competitive solutions are necessary to keep sellers in

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[80] Requiring a prescribed form for most of the marketplace.

[81] Shannon Buggs, Armando Villafranca, The Houston Chronicle, *Farmers calls it quits; Many Texans must switch home insurance*, Sept. 26, 2002, at A1.

the marketplace, meet demand with adequate supply, and stabilize prices. A rate rollback and/or other punitive price controls and restrictions on competition, by contrast, would devastate the market by evaporating supply when it is needed most. Policymakers in South Carolina focused first on availability rather than price[82] and were able to both stabilize costs and increase availability, even though the market hardened while their reforms were implemented. Policymakers concerned about their constituents' pain understandably want to attack the immediate problem of higher rates, but attempting to force private corporations to charge a price not determined by the laws of supply and demand will harm consumers by withering availability.

Texas should eliminate the benchmark system, pass a cost containment act empowering the department of insurance to monitor the marketplace for competition, and loosen restrictions on forms. Consumers would benefit from increased availability and choice but would not be left unprotected from improper company practices.

A number of mechanisms would protect consumers if rates were regulated by competition and forms by file and use review. First, supply and demand would control rates. Throughout the economy, competition regulates price for purchases far larger than insurance products, including the objects of insurance, homes and cars; for goods just as necessary as insurance, like food and gasoline; and for other financial services, like banking and securities products. Absence of government price controls does not equal the absence of regulation. Consumers would also receive full antitrust protections since, under the McCarran-Ferguson Act, if a state has not occupied the field with rate regulation, the antitrust laws apply to insurance as they do to the rest of the United States economy. Texas can further pass a law like Illinois' Cost Containment Act which requires the state to monitor the marketplace to ensure that competition exists and that prices are therefore being regulated by the laws of supply and demand. All the while, Texas can effectively police insurers by vigorously enforcing laws already on the books. Armed with consumer fraud, unfair trade practices, and antitrust laws, the Texas insurance commissioner and attorney general can protect consumers from unfair practices. In fact, without a rate regulatory statute in the Lloyds market, they successfully sued and reached a settlement with Farmers for a broad range of allegedly improper practices, some of which involved rating issues.

Eliminating the benchmark system and passing a cost containment act requiring the insurance commissioner to regularly report to the legislature on the state of competition in the market would both stimulate growth and provide protection. If the market was found to be non-competitive after a year or some other reasonable time, the legislature could then consider a file and use rate regulation system. That step would likely be unnecessary, since the state's commitment to the market should be met by a commitment of capital by sellers.

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[82] See Jim Parker, The Post and Courier, Charleston, SC, *State's auto insurance reform will take motorists on wild ride*, Sept. 7, 1997, at A1. ("Even insurance reform supporters agree the changes won't result in a wholesale rate reduction, but they will restore a competitive marketplace. 'What if you don't like the product? You shop around,' said Jim Byrd, spokesman for the S.C. Department of Insurance. The agency is developing a buyers' guide available in brochures and on the department's Internet home page, he said.")

## VI. CONCLUSION

Since it is no longer used in support of its sole original purpose -- ensuring carrier solvency by facilitating adequate rates -- government rate regulation is an obsolete tool badly mismatched to the modern competitive insurance marketplace. Price controls are used today as a political mechanism to keep rates down instead of up, but they do not help consumers. Instead, they stifle choice and availability while producing rates no lower than they would be under competition.

Homeowners insurance, though it greatly affects the common good, is not a government program. Instead, homes are insured by private risk bearers whose fiduciary responsibilities require them to conform their decision-making to the laws of economics. Companies can and will exit markets that threaten to destroy capital commitments. Such a result in Texas' market would be disastrous.

Illinois, which has codified the distinction, noted by Justice Lamar in German Alliance v. Lewis, between necessary regulation and price fixing, provides decades of proof that insurance consumers can be aggressively and efficiently protected without government rate regulation. Recent experiences in New Jersey and South Carolina vividly reinforce that more competition is the best remedy for a stressed market. By choosing market-based solutions instead of government price controls, Texas can empower its homeowners and ensure them a viable means of protecting their most valuable investments.

## VII. ABOUT THE AUTHOR AND THE PUBLISHER

### NATHANIEL S. SHAPO

Nathaniel S. Shapo is a partner in the law firm of Sonnenschein Nath & Rosenthal in Chicago. He served as the director of the Illinois Department of Insurance from January 1999 to January 2003. While director, he was twice elected to national office of the National Association of Insurance Commissioners and also twice elected chair of the NAIC midwestern zone. He chaired or co-chaired the NAIC Holocaust Task Force (which seeks compensation of unpaid Holocaust-era policies), the Functional Regulation Working Group (which negotiates jurisdictional issues with federal bank regulators), and the Consumer Protections Working Group (which develops proposals for making the regulatory system more responsive to consumer needs). As director, he wrote regulations for and implemented the Managed Care Reform and Patients Rights Act of 1999, which included the establishment of an Office of Consumer Health Insurance in the department of insurance. He passed a corporate governance bill which included an outside board of directors requirement and placed certain restrictions on money transfers between insurance companies and related non-risk bearing entities. He successfully obtained restitution for small face amount life insurance policyholders of Illinois companies who had paid higher premiums because of the color of their skin. Also, following department examinations which revealed millions of dollars in unpaid benefits, he passed a landmark regulation which requires companies to search for multiple policies on each insured life whenever a claim is received. Mr. Shapo graduated with honors from both the college and the law school of The University of Chicago, where he currently teaches insurance law and serves as a member of the law school's visiting committee.

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