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Deregulation, Pricing, And Availability Issues
In The Texas Homeowners' Insurance Market

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EXECUTIVE SUMMARY

Forces of hurricane intensity have been buffeting the homeowners' insurance market in Texas. The average premium for homeowners' insurance in Texas increased 112.8 percent from 1997 to the third quarter of 2002. This was the largest increase in the nation. Texas led the nation in the number of mold-related lawsuits in 2001, accounting for 70 percent of all mold claims filed nationally. The top five insurance companies in Texas saw mold claims rise over 500 percent in 2002, and, in spite of rate increases, insurers experienced loss ratios above 100 percent.

Consumers encountered higher prices, lowered coverages, and sometimes an inability to obtain insurance. Increasingly, there was pressure on legislators and insurance regulators to find a "fix."

"Fixing" price affordability and availability problems through legislative or regulatory actions, however, is fraught with difficulties. Insurance economics research shows that attempts to suppress insurance rates by regulatory intervention are counterproductive. Regulation generally drives prices up, rather than down, and exacerbates availability problems. Because they do not address the underlying causes of price increases, regulatory attempts to restrain the competitive market do not solve the problem.

Insurance economics scholars argue that if insurers were free to set rates, create forms, underwrite, and provide differentiated products, competitive market forces would tend to increase competition, increase availability, allow more choices for consumers, and counter spiraling price increases. This result is illustrated by South Carolina, which, in the two years following its relaxation of insurance market regulatory constraints, saw the number of companies selling automobile insurance double and rates go down.

Senate Bill 14 (SB 14), passed by the 78th Texas Legislature, was a rational economic attempt to address these issues by creating a more competition-driven environment. This bill moves Texas from a "flexible-band" to a "file and use" regulatory environment, ostensibly more toward deregulation. However, SB 14 had other provisions that may sow the seeds for later problems, such as a "subsequent disapproval" provision by which the commissioner may disapprove rates implemented and force rebates. This "subsequent disapproval" provision could squelch the intended benefits of SB 14. If "subsequent disapproval" is invoked with great frequency or with too long a lag after implemented rates have been used, it would essentially make Texas a more regulated, "prior approval" environment.

Add to this the removal of the regulatory "safety valve," previously furnished by the Lloyd's insurance market (Lloyd's now being regulated by SB 14), and we have the explosive potential of significant market disruption, increased availability problems, and a much more stringent regulatory setting than currently exists. It all depends upon the commissioner's actions.

Recommendations:

- The commissioner of insurance should develop implementation guidelines for:
    - using "subsequent disapproval" as a last resort or for exceptional circumstances and
    - "file and use" in the least regulatory form.
- The Texas Legislature should enact a long-term plan for phasing out regulatory activities and should allow competitive pricing to determine homeowners' insurance rates.

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INTRODUCTION

The purpose of this study is to analyze deregulation and price and availability issues in the homeowners' insurance market in Texas, with particular consideration of recent legislative history and its potential impact on the market. While price and availability problems in homeowners' insurance have been concerns for decades, they gained greater prominence during the late 1990s and early 2000s after mold, water damage, and natural catastrophe claims – hurricanes, hail, wind, flood damage – thrust insurers into a reconsideration of adequate pricing levels. Key concerns of insurers were regulatory reaction time to approval of rate increases due to claim level changes, and the need for reassessment of the continued advisability of taking on new risk (writing new policies) or continuing to carry old risks (renewing business) without the ability to rapidly adjust premium levels to reflect changed loss expectations.

In Texas, the reaction of major carriers to the above regulatory concerns resulted in restrictions on writing new business by several of the major carriers (e.g., State Farm) and threatened non-renewal of all Texas homeowners' policies by Farmers Insurance (which later negotiated to refrain from withdrawal at least temporarily[1]).

Attempts to develop and institute a classification system for homeowners' insurance that excludes or surcharges separately for water damage or that incorporates credit scores of the insured have met with political and/or regulatory controversy in many states. Insurers also consider the inability to rapidly change policy forms to reflect changed risks a market problem affecting availability. When there is expected regulatory lag between the needed price (or form) change and the time of implementation, by the time an increase is approved, it may be necessary to apply for another – or it may be necessary to ask for a larger change initially, anticipating that the change will not be granted for some time. Regulators recognize this stair-step approach to rate changes can lead to potential overestimation of immediate loss coverage costs, and can oppose such increases as unjustified, furthering the pricing and availability tensions.

This study considers the above and other tensions among competing perceived objectives of regulation and the goals of price competition in competitive insurance markets. Insurance is a regulated industry, and political pressures can encourage regulators to suppress rate levels (disallow rate increases) in order to deal with pricing issues. This can lead to availability issues in turn, as insurers limit underwriting to manage costs, as illustrated above. Empirical studies as well as economic theory have demonstrated that stronger regulation has not reduced rates or provided consumers with other benefits. In fact, stricter regulation leads to severe market problems and a misallocation of economic resources.

This study suggests that a balance be struck between the competing objectives of insurance regulation and competitive market functioning to promote an efficient use of economic resources, with regulation present but reduced to a minimum core component that focuses on the fundamental goals – solvency and market conduct – that provide the rationale for insurance regulation. SB 14, when implemented in December 2004, stands a chance of moving markedly toward striking such a balance, if implemented correctly.

While the problems in the Texas homeowners' insurance market are particularly dramatic due to windstorms, hurricanes, floods, water damage, and mold,[2] the issues discussed in this paper are generic. Prices, in the absence of regulatory constraints, can adapt to changing expectations of losses without developing market availability issues. As illustrated by South Carolina, when regulatory constraints are relaxed, competition increases. For example, in the automobile insurance market the number of companies selling insurance doubled and the rates went down in the two years following South Carolina's deregulation of markets.[3]

As will be discussed, the regulatory structure in Texas prior to the passage of SB 14 in 2003 was a "flexible-band" system. In December 2004, the structure will become the more deregulated "file and use" system. As discussed in this paper, however, because the non-rate-regulated insurance schemes such as Lloyd's associations previously provided a "safety valve" for regulatory constraints in Texas, and because this regulatory exemption is now removed, and because SB 14 had a "subsequent disapproval" provision for disallowing rate changes if the commissioner decides, the actual regulatory effect of SB 14 (increased or decreased regulation) depends upon exactly how it is implemented. If the "subsequent disapproval" provision is used too often, the regulatory environment will be treated by insurers as a "prior approval" environment, and as insurance economists have shown, in this case one can expect problems of pricing and availability to rise, rather than fall, and the residual markets to grow. It is all up to the commissioner.

BACKGROUND

The United States has a long history of price and availability problems in personal lines of insurance. In Texas, the problem of lack of availability for rural residents dates back to the founding of the Republic. More recently, the increasing cost and curtailed availability due to price and policy form regulatory constraints on insurers have heightened concerns about the ability of some consumers to obtain essential coverage at "affordable" prices.[4]

Pricing Constraints Imposed on the Market

Due to the essential nature of homeowners' insurance coverage for leveraged real estate transactions (e.g., the existence of a mortgage for most homeowners), affordability and availability problems have brought intense political pressures to suppress rates or control policy forms (HO-A vs. HO-B forms) on insurance regulators, even though they cannot control the underlying costs that drive insurance rates. When regulators hold rates below expected insurance costs for some groups, availability problems tend to develop because rational profit-seeking insurers are unwilling to supply insurance coverage for such classes. Attempts to solve affordability problems through constraints on rates and forms have frequently made availability problems more severe in competitively structured insurance markets. That is, attempts to solve affordability problems through rate regulation have had adverse secondary economic effects that frequently created more severe availability problems (e.g., the constriction of writing in the homeowners' insurance experienced recently in Texas). Not unexpectedly, consumer demand exceeded the supply of coverage insurers were willing to offer when rates were suppressed below the equilibrium level in otherwise competitive markets. The automobile insurance markets in New Jersey and Massachusetts have provided dramatic examples of the negative economic effects of rate suppression and over-regulation in voluntary insurance markets. Illinois, with its regulatory freedom, illustrates an economic competitive success story at the other regulatory extreme, as does South Carolina.

Support of Residual Markets Imposed on the Voluntary Markets

To deal with availability problems for essential insurance for individuals unable to obtain coverage in the voluntary market, governmental programs, often called "residual market" plans (such as the FAIR plan, the MAP program, the Texas Windpool Insurance Association, and the Federal Flood Insurance Program), have been developed. These plans have frequently been subsidized by standard market insurance consumers in the voluntary market, what amounts to an unfair form of price discrimination; consumers in the voluntary market have to pay more for coverage than they otherwise would.[5] In fact, such subsidies distort the supply of insurance and the allocation of resources in a free market economy.

Insurance economists generally argue that under-pricing or overpricing of insurance coverage in competitive markets leads to misallocation of resources and inefficiency. As predicted by insurance economists, increased regulation in certain state markets (such as New Jersey and Massachusetts) has led to decreased availability and an increase in residual or government-controlled alternative markets.

Constraints on Rate Classification Variables

In addition to suppressing overall rate levels in an attempt to solve affordability problems, insurance regulators – or legislators, who are also "regulators" of insurance – have sometimes attempted to constrain permissible rate classifications, for example the current move by some parties to ban or significantly restrict the use of credit scoring for insurance.[6] The purposes of rate classification systems are to assess risks and to promote equity in the rate structure by varying rates in accordance with expected costs. Such risk assessment is necessary in competitive markets in order to determine and allocate fairly the expected costs associated with providing coverage. Proper risk assessment allows insurers to price according to expected costs and helps promote fair discrimination and bring about an efficient allocation of resources by providing proper economic incentives for loss control (loss prevention and reduction). Constraints on a cost-based risk assessment process ultimately lead to a misallocation of resources, market dislocations, cross-subsidies among consumers, and availability problems for some consumers in competitive markets.[7] Due to these adverse economic consequences, insurance economists normally argue that risk classification should not be constrained in order to deal with affordability problems through implicit subsidies in class rates.[8] Moreover, they would argue that insurers should be allowed to use all legal and socially acceptable classification information for pricing purposes in competitive insurance markets.

The Purpose and Characteristics of State Regulation

Because insurance involves a future performance contract, insurance regulation has always been concerned with the reliability or solvency of insurers. The primary purpose of insurance regulation, the promotion of solvency, is not achieved by regulating and controlling rates. Nevertheless, due to the major social and economic role played by insurance companies in compensating policyholders and their accident victims, and due to the compulsory aspects of some insurance coverage, state-level rate regulation has developed over time. Although life and health insurance rates are not regulated, historically, states have enacted rating laws in property and liability insurance, and regulators have been required to enforce these laws. Most state regulatory laws, such as those in Texas, indicate that rates should not be excessive, inadequate, or unfairly discriminatory.[9] Moreover, regulators in some states can prohibit the use of some classification rating factors and mandate classification systems. A few states also allow regulators to impose or set rates, which was the case in Texas until 1991.[10]

Public Policy Considerations Imposed Through Regulation

Historically, the excessiveness standard was intended to assure that insurance rates were reasonably related to expected insurance costs (losses and expenses), which is a supply side consideration. An affordability goal, on the other hand, reflects a demand side consideration involving income and wealth considerations of insurance consumers. When regulators attempt to set rates in accordance with a consumer's ability to pay rather than the expected costs associated with the coverage sought, the regulatory process tends to become highly politicized and arbitrary (c.f., Massachusetts). Regulators must make decisions about who should subsidize whom. Such attempts to establish rates unrelated to expected costs always create problems in competitive insurance markets because information about expected loss costs cannot be suppressed or controlled by regulators. Moreover, the resulting rates are unfairly discriminatory when they are not related to expected costs. Furthermore, subsidies to certain groups ultimately have to be paid by an implicit tax on other consumers in voluntary markets.

Societal Interest and Market Vitality in Tension

If insurers are constrained to charging rates below equilibrium levels in competitive insurance markets due to affordability and political considerations, availability and quality problems will tend to develop because insurers will have an incentive to reduce the supply of coverage and the quality of service provided. Attempts to solve affordability problems by holding rates below equilibrium levels indicated by expected costs through political actions always create availability problems and can ultimately result in quality and reliability problems.

AN OVERVIEW OF INSURANCE REGULATION IN TEXAS

The Historical Development of the Texas Insurance Market

The earliest insurance enterprises in Texas modeled their structure on Lloyd's of London, with wealthy individuals financing risks for a price. Continuity of insurance coverage and availability of coverage was problematic in this environment. However, as Texas grew, traditional life and fire insurance companies sprang up to support the state's growth, and these companies could survive the death of any particular wealthy individual. To both minimize marketing expenses and increase the size of their insured pools, these companies naturally concentrated on urban areas. This focus on the cities, however, left rural Texans without access to needed insurance (availability issues). The consequent lack of access to the ability to transfer or pool risks and to indemnify business and individual wealth from potentially disastrous losses did not diminish the needs of rural Texans for financial indemnification. Such needs still exist.

In the absence of any help from the "standard" insurance market, rural residents banded together to form "mutual assistance groups" in order to share risks among themselves. Organizations such as the Patrons of Husbandry and the Texas Farmers' Alliance encouraged and further developed the idea of mutual insurance. Subsequent westward migration into Texas, together with the prior experience of the German settlers coming to Texas, caused a rapid expansion of mutual or benevolent societies in the 1880s and 1890s.[11]

The Texas Legislature, recognizing the needs of this underserved constituency, supported the evolution of this "mutual assistance" vehicle by passing the Mutual Relief Association Act in 1885. Subsequently, organizations sprang up all over the state to provide "aid and assist each other to bear and make good any loss or damage which anyone of their members should suffer."[12] In their nascent stages, these groups tended to consist of residents in specific areas, often counties, where the members knew each other. This specific knowledge enabled the societies to avoid traditional insurance company problems such as moral hazards and to limit undesirable risks, thus allowing them to better control losses.[13] Inevitably, as the size and scope of these "mutual aid" associations grew, the interpersonal knowledge of the members diminished, thereby reducing the quality of their information. In today's terms, we might regard this as an inadvertent "relaxation" of underwriting abilities.

Initially, the Texas State Comptroller was responsible for regulating insurance companies. Following the Legislature's enactment of the 1876 State Constitution, regulation bounced from one new agency to another, finally residing with a commissioner of insurance. In 1911, the State Legislature defined what constituted a "county mutual insurance company" (a solution to the availability problem of property insurance in rural markets) and provided a list of acceptable hazards that they could underwrite. The Legislature permitted county mutuals to organize "for the purpose of [providing] insurance on the mutual or cooperative plan against loss or damage by fire, lightning, gas explosion, theft, windstorm and hail, and for all or either of such purposes."[14] Regulation of insurance companies, however, continued to remain haphazard until Texas adopted an Insurance Code in 1951.[15,16]

Development of Insurance Rate Regulation in the United States

If insurance is to be regulated, the question arises as to who should regulate it – the individual states or the federal government? The United States Supreme Court addressed this question in 1869 when it issued its landmark decision in *Paul v. Virginia*. The Court decided that the sale of an insurance policy was not a transaction of commerce, and hence not subject to federal regulation under the Commerce Clause of the U.S. Constitution. This decision provided the legal foundation for the continued regulation of insurance by the states for over 75 years.

However, the Supreme Court in 1944 reversed its earlier decision concerning the nature of the insurance transaction and ruled that insurance *was* commerce and, therefore, subject to federal laws, including anti-trust laws. In this landmark case, *U.S. v. South-Eastern Underwriters Association*, the Court's decision brought into question the entire system of state insurance regulation that had developed up to that time. It also cast doubt on the propriety of private rate-making bureaus' pooling loss data and setting rates for insurance companies.[17]

In response to *U.S. v. South-Eastern Underwriters Association*, the states and the insurance industry strongly encouraged Congress to enact the McCarran-Ferguson Act in 1945. This act basically indicated that the continued regulation of insurance by the states was in the public interest, and that no federal laws would be applicable to the business of insurance, unless they were specifically designated to apply to insurance by Congress. However, the act did provide that the federal anti-trust laws, the Sherman Act, the Clayton Act, and the Federal Trade Commission Act, would apply to the business of insurance to the extent that it was not regulated by individual states.[18] The McCarran-Ferguson Act provided the incentive for most states to pass legislation to regulate numerous insurance activities, including insurance rates and rate classifications. This state legislation was enacted primarily to continue states' control over insurance operations and to exempt insurance companies from federal statutes.

Most states enacted prior-approval types of rate regulatory laws in the late 1940s. These laws required prior approval of rates and rate classifications by the state regulatory authorities. However, a few states (including California, Montana, Idaho, and Missouri) adopted more competitive types of rate regulatory laws that allowed market forces greater freedom to determine equilibrium rate levels in insurance. In the 1960s and 1970s, various states repealed their restrictive rate regulatory statutes and adopted more competitive types of rate regulatory schemes because the fear of unregulated rate competition had diminished substantially. This move toward a more market-oriented approach to insurance issues continues today (e.g., Texas's SB 14 substantially reduces regulatory burdens in automobile and homeowners' insurance).

Recently, some groups have suggested doing away with the limited immunity in federal law that insurers are provided under the McCarran-Ferguson Act in order to encourage more price competition and less regulation (and more regulatory consistency) of property and liability insurance at the state level. In particular, the Anti-Trust Division of the U.S. Department of Justice in a 1977 report suggested that greater economic competition would be encouraged if insurers were able to choose a less regulated national system under which they would not have any anti-trust immunity.[19]

In 1978, the National Commission for the Review of Anti-Trust Rules and Procedures also proposed the repeal of the McCarran-Ferguson Act. Part of the motivation for the commission's recommendation appeared to be excessive and restrictive rate regulation by some states that prevented competitive market forces from operating in markets for property and liability insurance. These are still relevant concerns today.

Recent federal legislation intended to address the perceived deficiencies in insurance regulation – and the increased burden on multi-state insurers resulting from "over regulation" and differential treatment from state to state – includes the currently active so-called SMART regulatory reform legislation (State Modernization and Regulatory Transparency Act) sponsored by Rep. Mike Oxley, R-Ohio, chairman of the House Financial Services Committee, and Rep. Richard Baker, R-La., chairman of the Capital Markets Subcommittee. This bill would abolish rate regulation for property/casualty companies at the state level.[20] Two years after passage, no state could require the prior approval or review of rates for property-liability policies.

Other bills currently of interest in this federal deregulation vs. state regulatory debate include the "Insurance Industry Modernization and Consumer Protection Act," introduced in February 2002 by Representative John LaFalce, D-N.Y. This bill is intended "to establish an Office of the National Insurers within the Department of the Treasury to authorize the issuance of optional federal charters for carrying out the underwriting and sales of insurance or any other insurance operations."[21] It also repeals the McCarran-Ferguson Act.

In the interests of consistent state deregulation, the so-called the "Insurance Consumer Protection Act of 2003," introduced in the Senate in July 2003 by Senator Ernest "Fritz" Hollings, D-S.C, seeks to create a federal charter for insurers and again has the repeal of the McCarran-Ferguson Act as a part. It would establish a Federal Insurance Commission to investigate market conduct, regulate policies and rates, and oversee solvency. Again, the argument is to encourage deregulation in the industry and buttress a more competitive marketplace nationwide. The American Insurance Association has also put forward a detailed legislative proposal that calls for an optional federal insurance charter and proposes a Federal Insurance Chartering Office. It also includes a repeal of the McCarran-Ferguson Act.[22]

While some large nationwide insurers favor repeal of the McCarran-Ferguson Act, were it repealed, the nature of insurance regulation could change dramatically, and a new and uncertain regulatory environment could have an adverse economic impact on many small insurers, the states, and consumers.[23] Under the state regulatory structure, innovations in insurance regulations can be "tried out" in any of 50 regulatory environments without the possibility of unintended draconian impacts on companies nationwide. Learning from the different experiences of varying regulatory control in Massachusetts versus Illinois or South Carolina would be impossible with a single federal insurance system.

Ostensibly, the rationale for repeal of the McCarran-Ferguson Act is to increase deregulation and to create a unified – in this case federal – regulatory structure. However, if competitive rate regulatory laws in states such as Illinois and South Carolina have produced reasonable results benefiting the consumer, and if the deregulation experience in Texas is positive following the implementation of SB 14 beginning in December 2004, then this observed move toward more competition-oriented state laws could eliminate much of the motivation for repeal of the McCarran-Ferguson Act.

Why Is Insurance Regulated?

Insurance is regulated to a large extent because it involves a **future performance contract** that is dependent upon the solvency of the insurance firm. **Solvency is the most important goal of all insurance law and regulation**, according to a leading insurance scholar, the late Spencer Kimball. However, he indicated that the goal sought is not solvency in a strict technical sense, but a degree and type of solvency that assures the policy owner will be protected in any foreseeable situation. He referred to this concept as "solidity." That is, the insurance enterprise must be more than solvent, it must be financially solid. As a consequence, Kimball argued that solidity is the most important goal of insurance law.[24, 25]

Because insurance involves a future performance contract, prices must be set before costs are known. Insurance consumers pay the premium estimated by the insurer for expected costs in return for a promise that they will be compensated if any of the contingent losses covered under the contract occur during the policy period. The existence of a viable market for insurance is dependent upon the consumer's confidence in the insurer's integrity and ability to pay for potential future covered losses. Without some reasonable guarantee of future performance, the value of the insurance contract to consumers would be limited, and it would be difficult to maintain an economically viable insurance market. As a consequence, numerous aspects of the insurance market and mechanism are closely regulated in order to promote financial solidity, including the formation of insurers, minimum capital and surplus requirements, policy provisions, accounting procedures, marketing practices, agent licensing, investment of assets, claim settlement, some underwriting practices, and the prices charged for this intangible product and its associated services.

It has been argued that insurance should be regulated because insurance consumers are ignorant and because the product is complex. This is a faulty argument since the choice of insurance products is no more complex than that of many other products (and less complex than some) that are priced in the market. Additionally, the ignorance argument in favor of regulation is circular in a market setting where becoming informed consumes a precious commodity, time, that can be allocated elsewhere, and where this function is already being performed by others. A rational consumer may choose not to allocate his time to become informed if he is assured that the regulators are doing the comparisons for him. It is circular to argue that consumer ignorance is a rationale for regulation if the very regulation involved is the motivation for consumers being uninformed. Are regulations created because consumers are uninformed, or are consumers uninformed because insurance is regulated?

Should Insurance Rates be Regulated?

It is frequently suggested that rates are regulated in order to promote insurer solvency and to protect insurance consumers. However, it is not clear that rate regulation accomplishes these objectives in any economically meaningful way. Governmental interference in competitive markets generally creates more problems and costs than benefits for consumers.[26] The adverse results of regulatory intervention in insurance pricing decisions have been demonstrated in several U.S. jurisdictions, such as Massachusetts and New Jersey. Insurance economists have found that rate regulation causes availability problems, among other adverse consequences.

As noted earlier, historically, many state rate regulatory laws were passed in order to protect insurer loss-pooling practices for pricing purposes in property and liability insurance from prosecution under federal anti-trust laws. Most of these rate regulatory laws indicate that rates should not be inadequate, excessive, or unfairly discriminatory. The first two pricing standards seem to suggest that regulation is intended to keep insurance rates within some range of reasonableness. The last standard is based on equity concepts associated with perceived social welfare and ethical goals of our society. In recent years, an implicit goal of affordability also seems to have developed due to political pressures on regulators, especially in insurance markets with compulsory coverages (automobile) and extremely necessary coverages (homeowners').[27]

The non-excessive rate standard is apparently based on the assumption that insurance companies would tend to gouge consumers with high prices if they were not constrained by state regulators. Implicit in this is that consumers would be too unaware or ignorant to examine what competing market participants offer and change companies if a better price existed for the product. To a large extent, this assumption may be due to a lack of understanding and appreciation of how competitive market forces constrain prices. When consumers have reasonably adequate information and there are a large number of competitors in a market, competitive pricing pressures on insurers provide a better method for regulating and constraining rates than administrative regulation. The inadequacy standard seems to suggest that insurance companies might set rates too low to remain solvent if state regulators were not examining and approving their rate structure.[28] Apparently, investors would not be concerned about earning a competitive risk-adjusted rate of return on their invested funds under such a rationale. Why such altruistic investors only exist in insurance markets is not clear.

The rate standards for inadequacy and excessiveness seem to presume that competitive market forces associated with supply and demand conditions in a state insurance market cannot determine the equilibrium level of insurance rates without outside guidance and interference. The results of numerous research studies undermine this assumption, suggesting that there is little economic justification for rate regulation when competitive market forces can protect consumers and insurers just as well as state regulatory standards. Impersonal market forces can make the hard economic decisions that regulators cannot due to political considerations.

Many years ago, Kimball argued that free competition, rather than administrative regulation, is not only a better method to guarantee that rates will not be excessive, but is the only reliable way to decide the basic question of value associated with an insurance policy.

Moreover, with respect to the adequacy standard, he noted that adequate rates do not guarantee solvency because adequate income may be incompetently managed, and political pressures can easily affect an insurance commissioner's concern about adequate rates. Although the adequacy standard is concerned with solvency, Kimball suggests that a simpler and more direct way to promote solvency is to develop meaningful capital and surplus requirements.

With respect to the unfairly discriminatory rate standard, he argued that the cost associated with achievement of this goal is probably much greater than the value of it. Therefore, he asserted that it might be desirable to abandon rate regulation altogether, except for some minor continued concern about equitable classifications. In essence, he suggested that rate regulation could be eliminated because it produces results that are inadequate to justify its rather heavy costs, both monetary and in the suppression of management freedom.[29]

In a later article, Kimball suggested that a sound principle of operation for insurance regulation is that there should be no interference or intervention in the operation of the marketplace unless policymakers reasonably understand what they are trying to do. Not only may we make errors about the nature and extent of the problem, but we will surely fail to see all the side effects produced by the regulatory activity.[30]

A former superintendent of insurance in New York, Richard Stewart, has also suggested that regulatory concerns focus on market behavior rather than arbitrary and capricious rate regulation.[31] He implied that competition and regulation would work better together if competition were allowed to determine the market price of insurance with less restraint. Resources devoted to insurance regulation, according to Stewart, should be directed at helping consumers get the most insurance for their money, and regulatory efforts should be measured by how they affect the availability, reliability, and price of insurance.[32] Ernst Csiszar, current President of the National Association of Insurance Commissioners (NAIC) and Commissioner of Insurance for South Carolina, concurs with this assessment, saying that "in a competitive market, government has no business setting rates" and remarking that current regulations tend to "over-regulate the trivial while under-regulating the essentials."[33]

Types of Rate Regulation

The way insurance rates are regulated varies considerably among the states. Regulatory systems vary from state-made rates in Massachusetts (and Texas until 1991) to no rate regulation in Illinois (rates for auto and homeowners' must be filed for information purposes only).[34] Nevertheless, the rate regulatory laws in effect in various states and the District of Columbia have some similar economic characteristics and can be broadly classified as **competitive** and **constrained-competition laws** (or "less competitive" laws, in that constraints are placed on competitive market forces that determine equilibrium rate levels in a state). We delineate nine such types of regulatory laws, four of which can be classified as competitive and five of which can be classified as constrained-competitive**.** These will be listed in order from most competitive (least regulated) to least competitive (most regulated).

States with competitive rate regulatory laws basically allow competitive market forces associated with supply and demand to determine the equilibrium level of rates for the various insurance coverages. Four types of state rate regulatory laws, briefly discussed below, are usually included in the competitive classification: (1) no rate regulatory law or a state anti-trust law, (2) a no-filing law, (3) an information-filing law, and (4) a flex-rating law.[35]

The five types of regulatory laws placed in the constrained-competition category normally include (5) "file and use" laws, (6) modified prior-approval laws, (7) prior-approval laws, (8) statutory or advisory bureau rates, and (9) state-made rates. The laws in this classification place constraints on price competition and equilibrating market forces. They possess the common trait of regulating rates in a manner that does not allow the economic forces of supply and demand to be fully operative or to determine the equilibrium level of rates in the market for homeowners' insurance coverages. The majority of states today have rate regulatory laws that fall under this constrained-competition classification, which emphasizes the invisible hand of regulatory interference. This fact has been one of the reasons behind the effort at the federal level to modify or repeal the McCarran-Ferguson

9 Classifications of State Regulatory Laws

Competitive
- No rate regulatory law or a state anti-trust law
- No-filing laws
- Information-filing laws
- A flex-rating law

Constrained-competition
- "File and use" laws
- Modified prior-approval laws
- Prior-approval laws
- Statutory or advisory bureau rates
- State-made rates

Act, which exempts the business of insurance from federal regulation and, in particular, from the full scrutiny of the Sherman Anti-Trust Act and other federal anti-trust laws, namely to decrease insurance regulation.

Competitive Rate Regulatory Laws

(1) *No rate regulatory law or a state anti-trust law*. This system fosters the highest degree of competition of the regulatory systems in effect today. It grants full freedom to competitive market forces. Illinois is the only state with this type of regulatory approach. Rates are not directly controlled or regulated by the state, but homeowners' insurance rate-making practices are subject to sanctions specified by the state's anti-trust laws. This unique regulatory approach came into effect in 1971 when a competitive type of rating law expired and the Illinois Legislature failed to reach an agreement regarding how to extend the existing rate regulatory law, leaving the state without a regulatory statute.

(2) *No-filing law*. Under this type of statute, independent insurers and rating bureaus are not required either to file their rates with the regulatory authorities or to obtain approval of their rates from these authorities. California previously had this type of law, frequently referred to as an "open-competition" rating law because it is designed to promote price competition among insurers in the voluntary insurance market. Rating bureaus could only serve in an advisory capacity under this law. Their members and subscribers were not required to use their rates or rating plans. Insurers and rating bureaus, however, were required to maintain information on how their rates were developed in order that their rate structure could be examined to determine whether rates were reasonable and fair. The insurance commissioner had the authority to monitor rates on an *ex post* basis under this law even though no formal rate filings were required.

(3) *Information-filing law*. This type of law is similar to the no-filing type of statute except that insurance rates must be filed with state rate regulatory authorities for information purposes. The type of statute is frequently referred to as a "use and file" law. Rates can be put into effect and then filed later with the Insurance Department under this type of regulatory system. Rates developed by a rate-making organization are only advisory under this type of system because their members or subscribers are not required to use them.

(4) *Flex Rating law*. Under this type of law, rates can be changed or modified without prior regulatory approval if they fall within a certain percentage range around an approved benchmark rate structure. **Texas** had a flexible rating system for commercial and private-passenger automobile insurance, homeowners' insurance, and residential property coverage from 1991 until SB 14 takes effect in December 2004. Within a "flex band" of plus or minus 30 percent around promulgated benchmark rates, deviation was permitted by the statute without prior approval.

Constrained-Competition Rate Regulatory Laws

(5) "*File and use*" *laws*. Under this type of regulatory statute, rates must be filed with state rate regulatory authorities, but the rates developed by an insurer can be put into use without advance approval of these authorities in most cases. In some instances, the law may impose a waiting period before the rates may be used after they have been filed. Since rates are subject to review and possible disapproval after they have been put into use, this type of statute is sometimes referred to as a subsequent disapproval law. **Michigan** and **New York** have had this type of rate regulatory law and, as of December 2004, **Texas** will have this type of regulatory structure.

Depending on how this type of law is administered, it can be similar to the very competitive information-filing law discussed above or to the less competitive prior-approval law discussed below. In fact, if insurers fear subsequent disapproval because of prior regulatory behavior and practices, as has been expressed by insurers in Texas,[36] the results under the law could be similar to those under a prior-approval law, as insurers will behave as if the rates needed to be justified to the regulator before trusting that they can implement changes (because defending rate changes in hearings, and possibly rolling back prices, is costly to insurers). On the other hand, if the subsequent disapproval provision is used rarely, the effects of the law could be very similar to those under an information-filing law. This latter approach to "subsequent disapproval" is the position Texas Insurance Commissioner Jose Montemayor has stated he will take,[37] and which the authors of this study believe will occur. Assuming that the subsequent disapproval provision of SB 14 is rarely used by Commissioner Montemayor, the result of SB 14 will be deregulatory in nature and should assist market competition, increase the number of insurers writing business, decrease prices, and increase the attractiveness of Texas to businesses. As the implementation date of the new file and use law has not yet arrived, it is too early to know the actual path that will be taken, and insurers currently are taking a "wait and see" attitude.

(6) *Prior-approval laws.* Under this restrictive system of price regulation, insurance rates must be filed with the state regulatory authorities, and approval must be obtained from them before the new rates legally can be charged. This type of law is in effect in many states today, including **Pennsylvania, Maryland,** and **Washington**.

(7) *Statutory bureau laws*. Under this method of price regulation, insurers are required to become members of a designated private rating bureau before they are permitted to write a given insurance coverage in a state. However, insurers are usually allowed to deviate upward or downward from rates set by the rate-making organization, subject to some constraints. Prior approval from the rate regulatory authorities of bureau rates and any deviations from these rate levels is generally required. **North Carolina** has this type of regulatory system for both fire and automobile insurance rates.

(8) *State-made rates.* Under this type of regulation, a state agency sets the rates, and all insurers must utilize these rates. Texas had this type of rate regulatory law prior to 1991,

and **Massachusetts** still has state-set rates, which have resulted in some extreme problems in the market there in automobile and homeowners' insurance.

ECONOMIC COMPETITION IN THE TEXAS INSURANCE MARKET

The market for property and liability insurance in Texas (or for that matter in any insurance market in the world) is not perfectly competitive, since insurance contracts and services are not completely homogeneous, and there are market imperfections (such as regulatory constraints) that control market economic forces. Even when standardized policies, classifications, and territories are utilized, the nature of the intangible insurance product can differ from company to company due to different underwriting standards and claim settlement procedures used by insurers and the financial quality or solidity of the insurers selling the contract. As a consequence, insurers have a limited amount of control over the final price they charge for their coverage in most lines of insurance. In economic terms, the demand curve they face is less than perfectly elastic, so each insurer has a very small amount of monopoly power because of product differentiation and consumer loyalty.

This enables the firm to be a price maker rather than a price taker, which would be the case in a perfectly competitive market. Moreover, product differentiation allows consumers to enjoy and benefit from a wider range of insurance services. Products can be differentiated in various ways, even when there are standardized contracts. For example, differences in underwriting standards and claim settlement procedures influence loss costs and allow insurers to charge different actual prices for similar contracts, other things being equal. Differences in marketing systems used for distribution purposes also influence expenses and market prices. The greater choice of services under imperfect competition helps to compensate for any consumer welfare losses resulting from the lack of perfect competition in real-world markets.

The degree of control that firms have over price in a given line of insurance is determined by the number of competitors in the market, the extent of product differentiation, and the nature of price regulation. Restrictive rate regulation in some markets can undermine competitive pricing practices and disrupt market equilibrating adjustments provided by impersonal supply and demand forces. Such a result could occur under the new file and use system in Texas if regulators constrain the economic forces of supply and demand in insurance markets by disapproving implemented rates, forcing rollbacks and extra, unforeseen, and unpredictable costs on the insurer.

As a first-order approximation, an imperfect competition market model of workable competition seems to describe the economic behavior of firms in the insurance industry reasonably well. There are four basic characteristics generally associated this imperfect competition. First, there are a large number of sellers who tend to act independently of each other. The second major characteristic of this form of competition is product differentiation. Third, monopolistically competitive firms have a limited amount of control over price because the demand curve they face is less than perfectly elastic. Finally, entry and exit from such industries is relatively easy because there are no major barriers to entry or exit.

To a certain extent, all of these characteristics are found in the property and liability and homeowners' insurance industry in Texas. There are a large number of insurers selling most of the major types of coverages. Table 1 below lists the number of firms and company groups writing homeowners' insurance in Texas. As can be seen, while the number of groups and individual companies writing business has decreased over time, there are still enough companies writing business such that competition can be assumed. It is to be expected that following implementation of SB 14 in December 2004, even more companies will enter the market, assuming that the subsequent disapproval option for rates filed is not imposed too often.

Table 1

Number of Insurance Company Groups and Number of Companies Writing Homeowners' Insurance in Texas

Year	Number of Groups	Number of Companies
1997	69	166
1998	67	157
1999	64	147
2000	65	137
2001	62	129
2002	64	120
2003	62	101

As mentioned previously, specific coverages in homeowners' insurance can be differentiated between companies even when there are standardized contracts due to differences in underwriting standards, claim settlement procedures, and marketing distribution systems influencing loss costs. Hence insurers can charge different prices for similar contracts, other things being equal.

Entry and exit from the property and liability insurance industry are in principle relatively easy, although SB 14 now has imposed new constraints on withdrawing from a market. Capital and surplus requirements are relatively low when compared to capital requirements in many other industries. Ease of entry is also facilitated by low fixed costs. There is no need for large inventories or a major home office facility. Moreover, information and technological aspects of the business may be obtained without great difficulty because of the availability of consultants, reinsurance facilities, and the services of rating bureaus or advisory organizations. Furthermore, multiple line companies can add a line of insurance such as homeowners' without incurring many, if any, additional fixed costs because they already have the marketing force and facilities needed to write the line of coverage. This fact helps to make the homeowners' insurance market highly competitive.[38]

Similarly, it is relatively easy for an insurer to leave the market by reinsuring its existing coverages[39] or by selling out to another insurer. Moreover, state regulations influence the ease of exit since regulation is intended to prevent insolvency of insurers. State insurance laws provide for regulatory supervision of insurers whose financial condition appears to endanger the interest of creditors and policyholders. Thus, rehabilitation procedures sometimes preserve insurers who might have failed otherwise, or transfer their writings to other companies.[40] With respect to insolvency, therefore, competitive market forces may not be fully operative on the exit side.

While a relatively low degree of market concentration is usually considered important in order to have workable competition in a market, theoretically a market may not be competitive even when there are a large number of sellers if it is dominated by a few large sellers, assuming they are not low-price sellers. Thus, the distribution of firms by size in an industry is frequently considered important for regulation and anti-trust policy.

Based on a market share measure of concentration, the State Board of Insurance (now Texas Department of Insurance) concluded that the property and liability insurance market in Texas on an all-lines basis was not significantly concentrated in 1983. Two standards were considered in reaching this conclusion. First, a so-called "liberal" standard was used, which was based on the assumption that the concentration is not excessive if the four largest sellers have less than 50 percent of the market and the eight largest sellers have less than 70 percent of it. A stricter judgmental standard was also considered, which assumed concentration to be excessive if the eight largest firms had as much as 50 percent of the market and the 20 largest firms had as much as 75 percent of the market.[41]

In conducting their analysis, however, the insurance board considered all companies belonging to a group as being a single company for analytic purposes because of the potential lack of independent decision-making within a group. It should be noted that this ignores the fact that different rate structures are used by different insurers within a group selling a specific line of insurance, such as homeowners' insurance. It is not unusual for a group to have different insurers in the group for different risks (low risks), standard risks, and sub-standard risks (high risks that usually are placed in a county mutual). These insurers have different rate structures and clienteles because they are competing in different market segments with different expected costs for exposures or risks. Accordingly, it may be misleading to aggregate insurers in a group for concentration assessment. More lenient standards must be applied when considering groups of companies. The figure below shows the market concentrations for the top 12 insurers.

A more rigorous measure of competitiveness of a market is the so-called **Herfindahl Index**, the scale economists use to measure market concentration. The U.S. Department of Justice classifies any score under 1,000 as unconcentrated. A score of 10,000 represents a monopoly.[42] Table 2 presents the Herfindahl Index by year.

Table 2

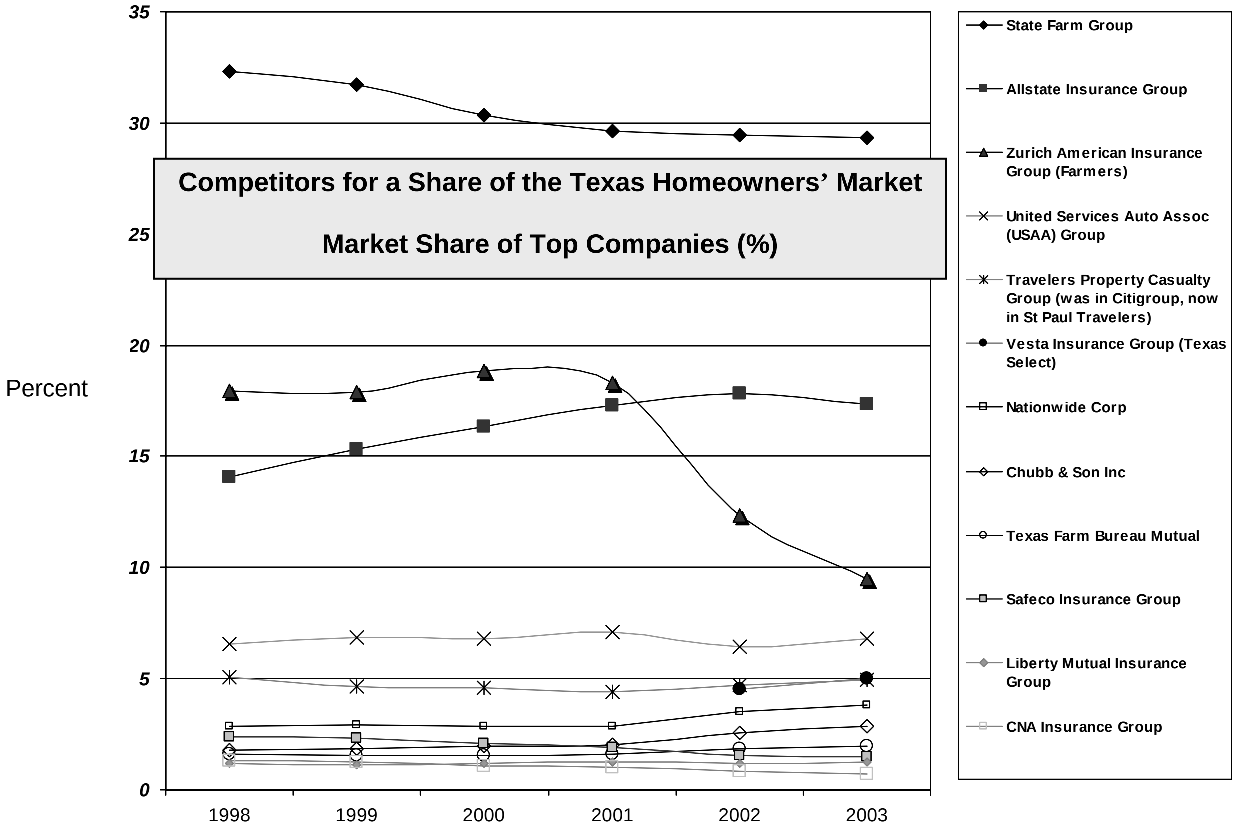
The Herfindahl Index for Competitiveness in the Texas Homeowners' Insurance Market

Year	Herfindahl Index
1998	1662.736
1999	1661.498
2000	1636.312
2001	1611.086
2002	1458.875
2003	1388.108

As can be seen, the Texas homeowners' market can be judged as workably competitive, and hence further regulations toward this goal are not needed.

Figure 1 indicates the major carriers present in the homeowners' market over the last six years, and the changes over time in their market share.

Figure 1



From Quarterly Legislative Report on Market Conditions – all companies incl. non rate regulated, 4th qtr 2001 unavailable

This again supports the proposition of there being a competitive environment for homeowners' insurance in Texas. Note particularly that there has been a decline in market share for two out of three of the largest insurance groups, State Farm and Zurich American, while Allstate increased slightly prior to 2004.

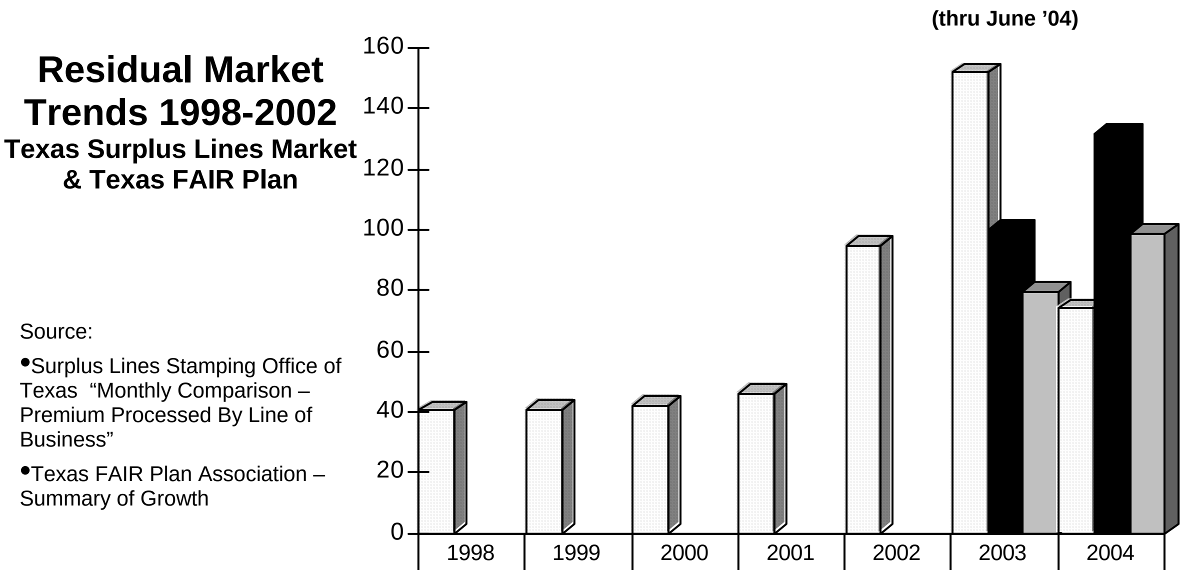
AVAILABILITY ISSUES IN THE TEXAS HOMEOWNERS' INSURANCE MARKET

Prior to SB 14, the homeowners' insurance market in Texas had become differentiated on two lines – companies formed Lloyd's facilities, or used their insurance exchange or county mutual companies to manage their homeowners' line, to enable competitive pricing of homeowners' insurance in a non-rate-regulated environment. These Lloyd's facilities provided a safety valve for regulatory problems in the standard market. Because Lloyd's companies were subject to much less policy and rate regulation, Lloyd's companies allowed for availability without much of the regulatory constraints mentioned previously. Consistent with the insurance economics predictions, under regulatory constraints demand will move to less regulated (or even residual) markets. In this regard, Texas Department of Insurance data show a dramatic movement of policies from the regulated homeowners' insurance market to the unregulated Lloyd's market. In 1993, for example, the unregulated market had a market share of approximately 37 percent while by 2001 it had risen to just over 90 percent.

Second, some companies filed policy coverage forms, with the intent of differentiating their products from the prescribed Texas HO-A and HO-B, and more along the lines of their nationwide product offerings. Some of these filings were approved in 2002. With the advent of water-damage related mold coverage challenges, and coverage imposition,[43] and subsequent attention to now inadequate rates, the Texas Department of Insurance published in April 2004 its *Quarterly Legislative Report on Market Conditions, 3rd Quarter 2003*.[44] In addition, the commissioner filed the 2003 Annual Report, describing program activities, legislative reforms, and market conditions.[45] On August 3, 2003, the department filed it first rate reduction notice under the authority of the new legislation, seeking rate reductions from 24 of 32 company groups.

During this period – from 2000 to 2003 – the insurance industry suffered significant unforeseen costs, the residual markets expanded to accept vast numbers of additional homeowners' clients, and the Texas FAIR Plan was instituted to breach the gap for individuals who wanted to purchase homes, change insurers, or purchase residential property insurance coverage in Texas. Rate levels for existing customers were adjusted to compensate for coverage dictates, as the Department of Insurance reviewed the abovementioned filings of coverage forms from carriers. As predicted by economic theory, regulatory constraints resulted in a movement toward other less regulated markets (e.g., Lloyd's companies, excess and surplus companies),[46] or toward the residual market (FAIR Plan) with higher costs to consumers. Figure 2 below indicates the rapid written premium growth in the surplus lines markets and Texas FAIR Plan.

Figure 2



	1998	1999	2000	2001	2002	2003	2004
□ Surplus Lines Market: Homeowners premiums (in millions of dollars)	40.50	40.60	41.90	46.10	94.70	152.00	74.10
■ Texas FAIR Plan Policies in Force (HO-A, rental property, tenant and condo unitowners) (hundred thousands)						100.30	131.94
□ Texas FAIR Plan Written Premium in force (millions of dollars)						79.58	98.91

7,834 FAIR Plan policies, and $7.783 million in premiums written thru March '03)

Subsequent to the Legislature's adoption of SB 14, Texas Insurance Commissioner Montemayor confirmed that the hoped-for results of the 78th Legislature, and in particular SB 14, would be a more competition-driven environment that would ultimately work to the advantage of consumers, though with his office rests the responsibility to assure rates are fair. Through its *Proposed and Adopted Rules* as well as *Bulletins* and Commissioner *Orders*, the Department of Insurance communicates acceptance of filings, major implementations, and other findings that impact the industry. These major forms of communication in the past two years have been supplemented with statewide hearings on water damage and related mold coverage issues, the implementation of SB 14, the formation of the insurance legislative oversight committee,[47] a compliance workshop,[48] and a hearing hosted by the Department of Insurance and the Office of Public Insurance Counsel on September 9, 2004, to discuss the working draft of rules concerning filing requirements.[49]

The 78th Legislature requested that the insurance department oversee a file and use system for (among other lines) residential property insurance (see order 03-0128) and form a legislative oversight committee. The property and casualty legislative oversight committee includes the chair of the Senate Business and Commerce Committee, the chair of the House Committee on Insurance, two members of the Senate appointed by the lieutenant governor, two members of the House of Representatives appointed by the speaker of the house, and the public insurance counsel. They are to report in even-numbered years, by November 15, to provide

> "*any analysis of any problems caused by the property and casualty insurance regulation reform and make legislative recommendations to address problems and foster stability and availability within the industry*."

In the September 9, 2004, hearing related to these implementation issues, emphasis was placed on filing requirements. Industry representatives provided insight into their experience with other state regulatory systems, and a macro view of trends in filings regulation, in particular with state-specific regulatory practices that enhanced market presence. Examples of vibrant markets due in part to state regulatory filing systems were Ohio and Virginia, in contrast to Florida. In addition, thoughts were expressed by those presenting testimony that the regulatory emphasis and resources are most effectively spent on market conduct, fraud, and other public policy concerns, leaving rate adequacy to the open market, governed better by individual company structure and strategy, and risk-equilibrium-seeking market forces. Insurance economic research as described in the previous sections tends to support the appropriateness of this emphasis as well. Several speakers referred to the regulatory lag of the past, and the potential indeterminate results that may cause capital to seek markets other than Texas. The "subsequent disapproval" provision in SB 14 for homeowners' insurance rates was portrayed as a threat that will discourage entry to the Texas market as well as a disincentive to rate change filings. This "unknown" element, in concert with a non-specific, or open-ended, approval/disapproval time period, was a strong concern expressed at the September 2004 hearing. Without the safety valve currently provided by the lowly regulated Lloyd's associations (which will become equally regulated with the implementation of SB 14), there is concern surrounding the availability of homeowners' insurance if the "subsequent disapproval" provision is enforced too frequently, or with too long a lag after use has been begun.

There are a number of impediments to improvement in homeowners' insurance market vitality. These include but are not limited to:

- Requests for rates in excess of what's needed the current year, in anticipation of delays or resistance and appeals, with final "limited" approvals;
- Administrative costs of filings with perhaps large amounts of documentary information required within each filing to enable regulators to see the justification for rate increases or decreases;
- Resultant delays in adjusting rates to trends in losses and expenses;
- Increased uncertainty for insurers as to regulatory silence followed by subsequent disapproval and disgorgement of premiums; and
- Unrestored balance between voluntary and residual market due to anxiety concerning regulation.

PRICING ISSUES IN THE TEXAS HOMEOWNERS' INSURANCE MARKET

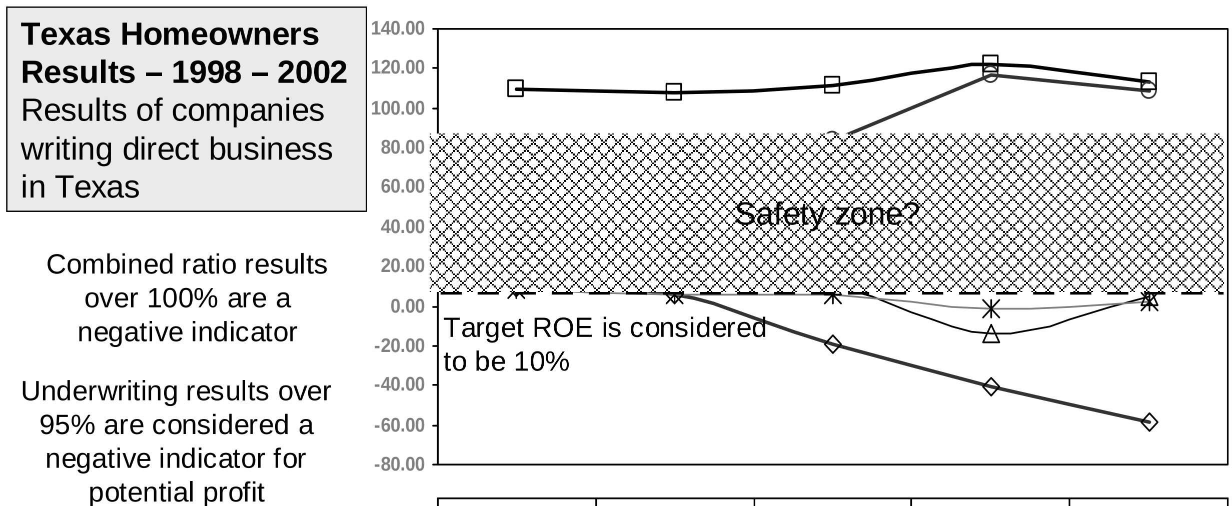
According to Fast Track Monitoring Reports (NAII/ISO) covering the period 1997 to the third quarter of 2002, the average premium for homeowners' insurance in Texas increased by 112.8 percent, the largest percentage increase in the nation. In all, 18 states (including Texas) had increases exceeding 40 percent, generally in states with the largest exposure to weather-related perils other than hurricanes.[50] Texas leads the nation in both the number of mold insurance claims (in 2001, 70 percent of all mold claims filed nationally were filed in Texas) and the number of mold-related lawsuits, with the top five insurance companies in Texas having had their mold claims rise over 500 percent in 2002. [51] During 2000-2001, over 44,000 mold claims were filed in Texas — at a cost of over $1 billion to insurers.[52] All of these factors, plus regulatory constraints on the ability of insurers to respond to market changes, resulted in availability problems as delineated in the previous section.

Time-to-market adjustments in the form of coverage and rate levels are crucial in an industry with coverage often dictated by court decisions and regulatory interpretations. The shadows of the regulatory lag experience in the past may dissipate in the months preceding December 2004, and, with measured and responsive approvals by the TDI, there may be increased interest in the Texas market, despite its weather-related catastrophe exposures. The full impact of SB 14 may not been seen for one, two, or even five years out. An appropriate balance between the objectives of rate regulation and price competition promotes efficient use of resources.

In a June 2004 report about overall insurance industry conditions, Dr. Robert Hartwig, chief economist for the Insurance Information Institutes, reported that much of the improvement in the underwriting and operating results enjoyed by insurer groups in the first quarter of 2004 "*…is derived from rating and underwriting actions taken in previous policy years that are only now bearing fruit. Ominously, top line growth during the first quarter of 2004 is well below expectations, with real growth in net written premiums likely to turn negative by year's end. Moreover, the fact that the industry's average return on surplus is an estimated 15%, despite a combined ratio of just 93.3, is a stark reminder that a renewed commitment to underwriting and pricing discipline are needed if the industry hopes to maintain Fortune 500 rates of return beyond the next four to five quarters.*" [53]

Whether Texas markets enjoy their just proportion of these improved results is yet to be seen – at the time of this writing, the hurricane season has begun. Figure 3 provides a look at the results for companies writing the homeowners' line of business from 1998 to 2002.

Figure 3



	1998	1999	2000	2001	2002
Texas Homeowners Profit (Loss) as percentage of premiums earned *	9.87	6.17	-19.42	-40.63	-58.49
Texas Homeowners Loss Ratio (incurred losses/earned premium) *	45.37	50.69	83.51	116.60	108.93
P & C Homeowners Industry Combined Ratio *****	109.4	108.2	111.4	121.7	113
P & C Industry Operating Income or Loss **	23.4	14.4	9.9	-13.8	5.3
P & C Industry Loss Ratio **	63.1	65.3	68.3	75.2	68.2
P & C Industry Annual Rate of	8.5	6	5.9	-1.2	2.2

The profitability outlook for Texas homeowners is dependent on a number of forces, including investment yield forecasts, target underwriting results for Texas, profit margins, solvency ratios, and of course unpredictable natural catastrophes that are committed for payment before actual incurred costs are known (recall that insurance is a future performance contract).

If, as is shown in Figure 3, the target return on equity (ROE) is 10 percent industry-wide, and if Texas is to stand on its own for each company doing business in the state of Texas, there is a long-term need to improve and discipline premium rates. There is a cyclical effect from catastrophe losses. In addition, cross-subsidies between companies in a group, and between states or lines of business, are not sustainable in the public interest. In fact, State Farm alleges that its time-sensitive repayment of a "loan" (actually a surplus debenture) is being disputed and/or delayed due to the actions of the TDI in pursuit of a promised rate rollback. Such actions may reduce insurers' incentives to manage or sustain their underwriting losses in Texas with cross-subsidies between group members, to the detriment of Texas consumers since such inhibition will necessitate the incorporation of increased "risk load" factors for premia or increased costs for consumers, or necessitate decreased writing in certain parts of the state for certain classes of consumers, leading to availability problems.

Concerns of some in the industry were voiced at the recent Insurance Council of Texas annual symposium. Would the commissioner and his staff's actions on rate filings in December engender trust in the industry and enable a market-driven, competitive environment? Would future rate needs be considered with enthusiasm, or met with delays and disputes? Would hard reinsurance markets be allowed as a factor in the approval of a rate change?

"From 1980 to 2000 fresh capital and ongoing profit retention resulted in an average surplus growth of 9.5%. …This accumulation of additional capital suggests investor confidence in the industry, despite the low ROE."[54]

CONCLUSIONS AND RECOMMENDATIONS FOR FURTHER DEVELOPMENTS IN TEXAS HOMEOWNERS' INSURANCE REGULATION

It should be noted that the Texas homeowners' insurance market presents special problems distinct from those in other parts of the United States. Susceptibility to hurricanes, windstorms, mold, and water damage claims have dramatically affected costs to insurers and accounts for about 85 percent of the observed differences in rates between Texas and the rest of the country. The regulated nature of the homeowners' insurance environment, however, has limited insurers' ability to respond via pricing and product changes in a rapid manner. As a consequence, much (more than 90 percent) of the homeowners' insurance business was driven to the Lloyd's insurance companies, which had no price and form regulation.

Accordingly, prices rose and legislators responded to price and availability problems with the passage of SB 14, moving Texas from a "flexible-band" regulatory environment to a "file and use" regulatory environment. It was hoped that this deregulation would stabilize the market and make more products available and make the market more competitive, stabilizing prices. While this bill has ostensibly moved the Texas regulatory environment toward more deregulation, it also included a "subsequent disapproval" provision by which the commissioner may disapprove rates implemented and force rebates if he deems them to be unreasonable or unjustified.

It is this "subsequent disapproval" provision which we recommend be studied with the intent of providing more guidance for how it will be implemented. While we firmly believe in Commissioner Montemayor and trust his statements concerning his intent to only use the "subsequent disapproval" as a last resort and in exceptional cases, he will not always be commissioner, and when he leaves at some point in the future, another commissioner may invoke the "subsequent disapproval" with great frequency making the actual effect of SB 14 to be a "prior-approval" regulatory environment. The result would be more regulated, not less regulated, than the flex-band environment we are now leaving.

The danger of increased regulation is exacerbated by the removal of the "safety valve" furnished by the Lloyd's market. Due to SB 14, insurers formerly protected by Lloyd's now come under the same regulations as the standard voluntary market. We now have the potential of significant market disruption, increased availability problems, and a more highly regulated setting than currently exists. Things could be much worse than before, since the vast majority of the market was unregulated prior to the bill, *but could conceivably be more tightly regulated*. It all depends on the choices of the insurance commissioner and how he implements the embedded "subsequent disapproval" provision.

The hearing held on September 9, 2004, discussed setting up procedures for disapproval, which will be helpful. We trust the current commissioner, but cannot know if the next commissioner will be as forward-thinking. Accordingly, we recommend that attention be given to setting implementation guidelines that transcend any particular commissioner in order to ensure that the intended benefits of deregulation expected to be achieved by SB 14 will continue to accrue past the current commissioner.

Recommendations:

- The commissioner of insurance should develop implementation guidelines for:
    - "subsequent disapproval" as a process for last resort or for exceptional circumstances and
    - "file and use" in the least regulatory form.

- The Texas Legislature should enact a long-term plan for phasing out regulatory activities and allow competitive pricing to determine homeowners' insurance rates.

ENDNOTES

[1] While there may be controversy as to why Farmers took this action, when a mutual or reciprocal insurance company such as Farmers, which is ostensibly "owned" by the policyholders and run by the managers for the benefit of its policyholders, decides that it is in the owners' best interests not to sell them insurance because it perceives that it cannot adjust prices satisfactorily in the regulated market to stay in business, it is a clear signal of regulatory problems. Controversy aside, other mutual insurance companies also have curtailed writing in volume and policy type.

[2] Texas Insurance Commissioner Jose Montemayor says about 85 percent of the observed differences in homeowners' insurance rates between Texas and the rest of the country can be explained by susceptibility to hurricanes, windstorms, mold, and water damage claims (*TDInsight* June/July 2004).

[3] Grace, Martin F., Klein, Robert W., and Phillips, Richard D., *Auto Insurance Reform: Salvation in South Carolina*, 2001 (*69 pages*).

[4] Ironically, regulation itself adds significantly to the cost of insurance to consumers. NAIC President Ernst Csiszar has noted that 8 percent to 15 percent of every premium dollar goes to underwriting the regulatory system ("Where does government end and the market begin" presented at the 2004 Mid-year Property and Casualty Insurance Symposium July 15, 2004, Austin, Texas).

[5] For example, in automobile insurance the residual market losses for private passenger automobile insurance in New Jersey and Massachusetts in 1990 were $396 million and $361 million, respectively. During 1990, automobile residual market plans generated underwriting losses of $1.2 billion for private insurers, according to a study by the Alliance of American Insurers. Over $800 of this underwriting loss was produced by residual markets for private passenger automobile insurance. The remaining $400 million was generated by commercial automobile residual markets. See: "Residual Auto Mkt Hit with 1.2B Loss in 1990," *National Underwriter* (Property/Casualty Ed.), December 7, 1992, p. 29.

[6] There is overwhelming statistical evidence that credit scoring predicts insured losses in automobile and homeowners' insurance (cf. Brockett, Patrick L. and Bruce Kellison, "Credit History and Insurance Losses: Is There a Connection?" *Texas Business Review*, March 2003, Bureau of Business Research, University of Texas at Austin) and that this predictability does not stem from information already contained in the other underwriting variables. In fact, no statistical study to the contrary has yet to be performed, yet the use of this variable is banned or constrained in some states.

[7] It has been empirically observed that states with more restrictions on classification systems also have larger residual markets (H. Grabowski, W. Kip Viscusi, and W.N. Evans, "Price and Availability Tradeoffs of Automobile Insurance Regulation," *The Journal of Risk and Insurance*, Vol. 61, No. 2, June 1989, pp. 275-299) so ultimately some consumers subsidize others and availability problems develop.

[8] Since perfect risk assessment is not possible, concerns about rating factors used for classification purposes are frequently raised in public debates. With imperfect and costly information, there are economic and statistical constraints on the ability of insurers to classify all risks in accordance with their true expected costs. Practical limits imposed by privacy considerations and civil rights concerns, however, always have to be recognized in the use of information for risk assessment purposes.

[9] Texas Insurance Code, Chapter 1, Section 13.01 Article 1.02 requires insurance rates be just, fair, reasonable, adequate, not confiscatory and not excessive for the risks to which they apply, and not unfairly discriminatory.

[10] Subsequent to the law change in 1991, Texas implemented a flex-rating law for automobile and homeowners' insurance in which the insurance department only set a benchmark rate from which insurers could deviate within some boundaries. More recently, with the passage of SB 14, as of December 2004, the state will have implemented a more liberal "file and use" system for rate regulation. These rating systems will be explained in later sections.

[11] Douglas Caddy, *Understanding Texas Insurance*, xv (Foreword: Henry C. Dethloff) (1984).

[12] *Id.* at xvi.

[13] George L. Curry, *General Insurance for Texas* 12 (1955).

[14] Tex. Sess. L '51, ch. 491, art. 17.01, 1036.

[15] *Tex. Ins. Code Ann*. (Vernon Supp. 1997); Tex. Sess. L '51.

[16] The 1955 Legislature put a cap on the number of county mutual insurance companies that would ever exist at the number then existing and expanded the permissible lines of coverage that qualified statewide county mutual companies could write to include "all lines of automobile insurance."
[17] Robert C. Witt and Harry Miller, "Rate Regulation, Competition, and Underwriting Risk in Automobile Insurance Markets," *CPCU Journal*, December 1981, pp. 202-220.
[18] Of course, any agreement to or act of boycott, coercion, or intimidation remains subject to prohibition under the Sherman Act.
[19]U.S. Department of Justice, *The Pricing and Marketing of Insurance*, The Report of the U.S. Department of Justice to the Task Group on Anti-Trust Immunity (Washington, DC: U.S. Gov't. Printing Office, January 1977).
[20] "Draft Regulatory Overhaul Draws Praise From Insurance Groups" Washington, August 25, 2004 (*BestWire*).
[21] "The Federal Charter: A Primer" by the CPCU Society's Connecticut Chapter Research Committee , *CPCU eJournal*, Vol. 57 No. 9, September 2004 pp. 1-17.
[22] ibid
[23] If the Act were repealed, the result would probably be a duplicate layer of regulation at the federal level, which would not seem to be economically desirable. Repeal would also expose insurers to the threat of additional, costly litigation arising out of alleged anti-trust violations and to uncertainty surrounding the economically useful exchange of underwriting information and loss experience.
[24] Spencer L. Kimball, "The Goals of Insurance Law: Means vs. Ends," *The Journal of Risk and Insurance*, Vol. 29, No. 1, March 1962, pp. 19-29.
[25] We would add that market conduct should also be regulated because of the inability of the consumer to replace coverage after the fact, or know and respond to unethical insurance actions. Licensing and registration requirements fit into this context. Much of the needed legal power for this control, however, already exists under unfair trade practices and contract law.
[26] Kimball 1962 op cit; Richard E. Stewart, "Ritual and Reality in Insurance and Regulation," *Insurance, Government, and Social Policy*, Edited by Spencer L. Kimball and Herbert S. Denenberg, (Homewood, IL: Richard D. Irwin, Inc., 1969); Witt and Miller (1981), op. cit.; R. Ippolito, "The Affects of Price Regulation in the Automobile Insurance Industry," *Journal of Law and Economics*, Vol. 22, (April, 1979), pp. 55-89; Paul Joskow, "Cartels, Competition and Regulation in the Property-Liability Insurance Industry," *The Bell Journal of Economics*, Vol. 4 (1973), pp. 375-427; Scott Harrington, "The Impact of Rate Regulation on Prices and Underwriting Results in Property-Liability Insurance Industry: A Survey," *The Journal of Risk and Insurance*, Vol. 51 (December, 1984), pp. 577-623; *General Accounting Office of the United States, Auto Insurance: Regulation Affects Cost and Availability*, GAO/OCE-86-2 (August, 1986).
[27] For example, Texas Insurance Commissioner Jose Montemayor speaks of being "… committed to ensuring that every Texas homeowner pays a rate that is fair and justified." (*TDInsight* June/July 2004 page 5).
[28] Stewart (1969), .op. cit.
[29] Kimball (1962).op. cit.
[30] Spencer L. Kimball, "The Regulation of Insurance," *Insurance, Government, and Social Policy*, Edited by Spencer L. Kimball and Herbert S. Denenberg (Homewood, IL: Richard D. Irwin, Inc., 1969), pp. 10-11.
[31] Stewart (1969), .op. cit.
[32] Ibid., p. 32.
[33] Quotes from notes taken by authors from Csiszar's speech "Where does government end and the market begin" presented at the 2004 Mid-year Property and Casualty Insurance Symposium July 15, 2004, Austin, Texas.
[34] In some states, such as Texas until the passage of SB 14 in 2003, there are substantial segments of the market that are unregulated with respect to rates and forms (e.g., Lloyd's Associations in homeowners' insurance and County Mutual insurers in automobile insurance) while other segments are regulated. These serve as a "safety valve" for the voluntary market when issues of availability arise because of pricing regulatory constraints.
[35]See Witt and Miller (1981). op. cit.

[36] From at the 2004 Mid-year Property and Casualty Insurance Symposium July 15, 2004, Austin, Texas, and from personal interviews with the authors.
[37] From at the 2004 Mid-year Property and Casualty Insurance Symposium July 15, 2004, Austin, Texas, from *TDInsight* June/July 2004, and from personal interview with the authors.
[38]See: Robert C. Witt and Paul R. Aird, "Contestable Markets for Property-Liability Insurance: Is Rate and Form Regulation Necessary?" *CPCU Journal*, Vol. 45, No. 1 (March, 1992), pp. 30-48.
[39] See: Patrick L. Brockett and Robert C. Witt, "An Overview of the Reinsurance and the Reinsurance Markets," *Journal of Insurance Regulation* (March 1991), Vol. 9, No. 3, 432-454.
[40] See: United States General Accounting Office (GAO), *Insurance Regulation: Problems in the State Monitoring of Property-Casualty Insurer Solvency*, September 1989; and "Best's Insolvency Study of Property-Casualty Insurers 1969-1990: Executive Summary and Recommendations," *Best's Review*, August 1991, pp. 16-23.
[41]Texas Department of Insurance Annual Report, August 31, 1991, p. 49.
[42]The Herfindahl-Hirshman Index (Herfindahl Index for short) is computed by summing the squared market shares in percentage terms of all business firms competing in a market for some defined product or service. As mentioned, the U.S. Justice Department uses the Herfindahl Index to evaluate the competitive effects of mergers and acquisitions in a given industry or market. Values in excess of 1800 suggest an industry is highly concentrated; whereas Herfindahl Index values between 1000 and 1800 are deemed to be moderately concentrated according to Justice Department standards.
[43] Texas Department of Insurance – exempt filing notification pursuant to the *Insurance Code*, Chapter 5, Subchapter l, Article 5.96 Adoption of Amendatory Mandatory Endorsements, Mandatory Offer Endorsements, An Amendment to Endorsement No. HO-170, and Amendments to the Texas Personal Lines Manual Rules to Modify Coverage for Mold and Other Fungi; and Amendments to the Texas Statistical Plan for Residential Risks.
[44] *Quarterly Legislative Report on Market Conditions, 3rd Quarter 2003.*
[45] *2004 Annual Report to Governor*, Part One (year ending August 31, 2003).
[46] See Patrick L. Brockett, Robert C. Witt and Paul Aird, "An Economic Overview of the Excess and Surplus Lines Insurance," *Journal of Insurance Regulation* (1990), Vol. 9, No. 2, 234-258.
[47] Property and Casualty Insurance Legislative Oversight Committee *(Insurance Code, Article 21.49-20(a).*
[48] Texas Department of Insurance (TDI) Property & Casualty 2004 Compliance Workshop.
[49]*Informal Working Draft of Rules Relating to 28 TAC §5.9301; 28 TAC §5.9303; 28 TAC §5.9310; 28 TAC §5.9320; 28 TAC §§5.9330 - 5.9333; 28 TAC §§5.9340 - 5.9342; 28 TAC §§5.9350 - 5.9352; 28 TAC §§5.9355 - 5.9357 and audio recording of minutes.*
[50] Martin Grace and Robert Klein, "Overview of Recent Developments in Residential & Commercial Property Insurance" Final Report Prepared for The National Association of Realtors, July 8, 2003.
[51] ibid
[52] ibid
[53] "2004 – First Quarter Results" By Robert P. Hartwig, Ph.D. Senior Vice President & Chief Economist, Insurance Information Institute, June 29, 2004.
[54] Source: A M Best, Swiss Re Research & Consulting, May 2001.

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