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Policy Perspective

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Homeowners' Insurance:
Moving Toward Competition or More Regulation?

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INTRODUCTION

Texans experienced price increases in their homeowners' insurance policies averaging 45 percent during the first three years of this decade. Much of the increase was driven by an explosion in claims for mold damage; these claims rose by 1,300 percent in less than two years. The rate increases prompted regulatory and legislative actions attempting to control insurance rates.

The Texas Department of Insurance responded first to the rate increases in 2002, with a combination of relaxed regulations on mandated coverage and increased scrutiny of rate setting.

Many members of the Texas Legislature recognized that the regulatory system in place needed changing to provide a more stable business environment. Their answer was Senate Bill 14, which passed in 2003. SB 14 removed the statutory loophole that allowed most homeowners' policies to be issued without price regulations. Instead, insurance prices became subject to prior approval by the commissioner of insurance. With this new regulatory authority the commissioner of insurance ordered rate reductions of up to 31 percent for 30 insurers in Texas.

In December 2004, the second phase of SB 14 went into effect. This replaced prior approval with a file and use system that offers the potential of a competitive market with improved availability and reduced prices.

The insurance market has improved significantly since 2002. Rates have generally decreased, and many insurance companies have been showing profits. Yet the political climate regarding insurance has not correspondingly improved.

This year, at least two bills supported by various members of the legislative leadership, would turn back the clock on last session's reforms by imposing substantial restrictions on the ability of insurers to set their own rates, and punish any company that challenges a finding by the commissioner of insurance in court. Other bills would restrict or eliminate the ability of insurance companies to adjust their rates for risk through the use of credit scoring or territorial definitions. And in March, the commissioner of insurance required companies to file and justify their homeowners' rates based on reports of low loss ratios in 2004.

This paper will examine the causes of the increased losses and premiums in the early 2000s, the regulatory and legislative remedies pursued in response, and the need for any additional reforms in 2005 and beyond.

REGULATORY BACKGROUND

Prior to SB 14, the homeowners' insurance market in Texas had become differentiated along two lines – regulated and competitive. Though Texas officially used a benchmarking system to regulate homeowners' insurance, a loophole in the law allowed companies to

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form Lloyd's facilities to manage their homeowners' line and offer 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, enabling homeowners to have access to insurance when the benchmark system was rationing availability. Texas Department of Insurance data show a dramatic movement of policies from the regulated homeowners' insurance market to the unregulated Lloyd's market: in 1987, the unregulated market had a market share of approximately 20 percent; by 2001 it had risen to 95 percent (Property and Casualty Insurance Legislative Oversight Committee).

Yet even later critics of the Lloyd's exception admitted that the system worked. Rep. John Smithee, R-Amarillo, chairman of the House Insurance Committee, said, "[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."

However, there were two problems with the system.

First, rate deregulation in Texas was the exception, not the rule. The Lloyd's exception was not designed to serve the majority of the homeowners' market in Texas and did not allow national companies to sell policies in Texas. So even though most companies had migrated to using the Lloyd's exemption, this system did not offer companies a regulatory climate conducive to committing long-term capital to the Texas market.

Second, though rates were largely deregulated, coverage was not. Most insurers in Texas were required to offer homeowners' policies using the HO-B form, which mandated certain coverage. Water-related damage, including mold, was included in the mandated coverage. So when mold claims began skyrocketing, companies had few ways available to respond other than raising rates or leaving the market altogether.

The Rise of "Toxic" Mold Claims

Mold has existed for thousands of years and is commonly found in homes and buildings and will grow naturally indoors where there is moisture. An estimated 70 percent of all homes have mold behind the walls, and it is unlikely that there is a home in the world without some Stachybotrys spores in it (Gots). Yet mold toxins at indoor environmental levels have never been shown scientifically to cause any health problems or illness, nor are chronic diseases characterized by symptoms alone due to mold. However, mold may commonly cause hay fever-like allergy symptoms (Gots).

Despite the scientific evidence of the relatively benign nature of indoor mold, claims by Texas policyholders for mold damage began to skyrocket in 2000. From the first quarter of 2000 to the fourth quarter of 2001, the total number of mold claims grew from 1,050 to 14,706 – a 1,300 percent increase (Hotra and Martin).

Mold claims are expensive, averaging between $15,000 and $30,000 per claim. Claims can climb as high as $100,000, far exceeding a typical water-damage claim. The impact of these claims on policyholders' rates was significant. The average cost of mold claims per policyholder per year increased from $24.32 to $300.50 at the end of 2001, having peaked in the third quarter of 2001 at $444.35 (Hotra and Martin).

Additionally, Texas accounted for 70 percent of all new mold claims in 2001, even though the state has only 7.5 percent of the U.S. population (Hotra and Martin).

It is hard to explain the meteoric rise of mold claims in Texas during this period based on the scientific evidence. Mold is relatively benign, has existed in Texas homes for years and the Texas climate is no more conducive to the growth of mold than many other states.

Several other factors, however, could have played a large role in the increased claims.

The first was the mandated mold coverage under Texas Department of Insurance regulations. This led to 96 percent of homeowners' being in a position to require insurance companies to pay for mold remediation.

Second, many trial lawyers and mold remediation firms began taking advantage of questionable science to make money. Two studies by the U.S. Center for Disease Control in 1994 and 1997 initially linked exposure to stachybotrys chartarum mold to lung damage in a group of infants in Cleveland. Though the CDC took the very unusual step in 2000 of retracting its endorsement of the reports because of faulty methodology, the damage had already been done (*Mold Reporter).*

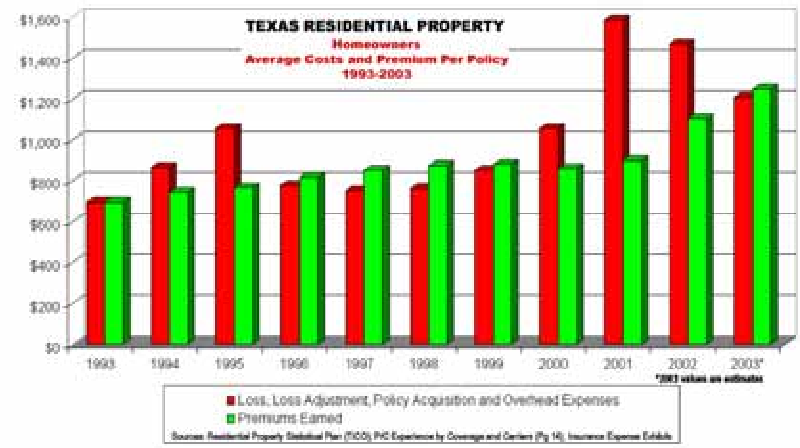
Bolstered by their success in asbestos litigation, members of the plaintiffs' bar began adopting similar tactics to pursue mold claims. For instance, one web site claimed that "toxic mold is still vastly unknown about by the medical community…. According to the Environmental Assessment Association, toxic mold concern is mounting as the medical field is better understanding the effects and ailments that toxic mold can cause" (Toxic Mold and Tort News Online). This claim was made in 2003, despite mounting evidence to the contrary. The same web site provided links that people can follow to find a "toxic mold lawyer" in their state.

The third factor was the fear raised in the general population by the publicity generated from these dubious claims. In 1999, a central Texas woman filed a lawsuit for $100 million against her insurance company claiming that her family had become ill from mold contamination. She was awarded $32 million in 2001 (Associated Press).

Erin Brockovich, the single mom-turned environmental health activist whom Julia Roberts portrayed in her Oscar award-winning role, declared "toxic" mold to be her new pet project. Ed McMahon also made headlines for his lawsuit in which he received $7 million in damages – he claimed that fungus had killed his dog (Hotra and Martin).

The fear tactics worked. Justin Schmitt, corporate relations manager at Allstate, said, "In major markets, when a story referred to 'toxic' or 'black' mold, we saw a spike in claims. People were calling us when they saw mold on their bread or mold on their shower walls. Any presence of mold would trigger panic" (*Houston Chronicle* 2002). According to a poll released in December 2001, nearly 80 percent of Texans believed that mold in the home could cause serious health problems (*Dallas Morning News* 2001).

The resulting explosion in claims put a great strain on the insurance industry in Texas. TDI figures show that after several years where costs and expenses per policy were near parity, costs exploded over the next three years, resulting in heavy losses.



Source: Property and Casualty Insurance Legislative Oversight Committee

In 2000, costs per policy exceeded premiums by almost $200. For 2001 and 2002, the numbers were over $700 and $300, respectively. Overall, homeowners' claims rose from $1.3 billion in 1999 to $2.9 billion in 2001. The ten year rate of return for the period ending in 2002 was -5.2 percent (Texas Coalition of Affordable Insurance Solutions).

Responses to the Mold-Induced Crisis

Insurance companies responded predictably to the increase in claims by trying to reduce their losses. Increased premiums was one response – the average cost of a homeowners' policy in Texas rose from over $800 in 2000 to just over $1200 in 2003 (Property and Casualty Insurance Legislative Oversight Committee). Some insurers stopped writing new policies in the state, while others left the market altogether, with the number of companies writing homeowners' insurance in Texas decreasing from 137 in 2000 to 101 in 2003 (Brockett and Arnold).

Insurers who stayed in the market attempted to change their policies by removing coverage for mold damage. However, this usually required approval from state regulators before it could be implemented, and such approval was slow in coming in the politically charged environment.

Political pressure brought on by tightly contested races and sensational media coverage led many policymakers and interest groups to ignore or misdiagnose the true causes of the crisis. Instead, the blame was often placed on companies for charging their customers too much.

Some critics seemed to blame the motives of the insurance companies,[1] while others just didn't have much faith that the market was working.[2]

However, Nathaniel Shapo, the former director of the Illinois department of insurance, described the situation differently in his April 2003 study of the crisis. He wrote:

> 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.
> - 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

A fourth cause of the uncertain and extreme conditions that Shapo did not mention was the harmful regulatory framework which limited the responses available to the companies.

It is difficult to tell how much of the political pressure was coming from consumers of homeowners' insurance instead of special interests. While complaints to TDI regarding rate increases for homeowners' insurance increased from 283 in calendar year 2001 to 2,415 through November 2002 (Texas Department of Insurance Biennial Report), this was still a small number compared to the size of the Texas market.

Nevertheless, TDI moved quickly to regulate rating practices of insurance companies. It filed a lawsuit against the Farmers Insurance Group for illegal rating practices, and attempted to bar insurers from using past water damage claims as a reason to deny home insurance coverage.

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

Despite all of the political turmoil, the lessening of regulations on coverage began to have a significant effect on premiums and losses. Mold claims plummeted in 2003, and for the first time in four years, premiums collected exceeded losses and costs, if only slightly.

Premiums for individual policies also began to stabilize, and in many cases, decreased significantly. In its calculations based on a theoretical policy with a premium of $1,000, the department estimated that the 2002 changes in mandated coverage saved consumers an average of 13.5 percent. For 2003, the department estimated that overall premiums increased by only 1.4 percent, much less than the 40 plus percent increase over the two previous years (Texas Department of Insurance SB 310 Report).

These favorable changes were already taking effect when the Texas Legislature met in 2003, strong evidence that the combination of market responses and the relaxation of mandates on coverage had brought the homeowners' insurance crisis to an end before the

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[1]Dan Lambe of Texas Watch said, "Until we pass legislation that insures 100 percent rate regulation, 100 percent rate protection, we're leaving the door open for abuses by insurance companies" (*Austin American-Statesman*). Additionally, Tony Sanchez, the Democratic gubernatorial nominee, repeatedly criticized both industry and the incumbent, Governor Rick Perry over the issue. And Perry let the industry know that policymakers were going to address the public perception that "a handful of companies [were] bringing the state to its knees" (*Dallas Morning News*, Sept. 2002).

[2]Rep. Smithee said, "[T]he 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. … [W]e got into what was a pure seller's market. They could basically charge whatever they wanted to charge" (*Austin American-Statesman*).

legislature came into session. And this evidence was available to policymakers at the time; in fact, some of it was available months before.

For instance, an August 29, 2002 article in the *Dallas Morning News* featured a headline saying, “Home insurance up, but not much. Rates have stabilized since May, stay above state standard in area.” The article went on to report, “In Dallas County, the average premium on a $100,000 brick veneer home with a 1 percent deductible is $990 for the 39 companies selling policies in the area. In May, the average was $979” (*Dallas Morning News,* August 29, 2002).

Additionally, TDI reported to the Texas Legislature in March 2003 that “[r]ates in 2003 appear to be leveling off. Barring any further destabilization of the market, the Department anticipates this trend to continue on a broad scale, if not improve.” The department also acknowledged that without the lessening of regulation on coverage options, rates could have increased at least 20 percent higher than they did (Texas Department of Insurance SB 310 Report).

Despite these facts, there was still significant political pressure on the legislature to control the price of homeowners’ insurance. So the legislative response to the crisis mixed increased short-term regulation to control prices with the potential for long-term price deregulation.

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

Most of the companies agreed to the rate cuts, with 22 companies taking a one-time reduction and six of the companies phasing them in. But two of the companies, Farmers and State Farm, challenged the cuts in state district court. The challenge was successful, and the court granted a summary judgment against the state based on procedural grounds. Subsequent to the judgment, Farmers settled its dispute with TDI; but the department is still pursuing its legal battle with State Farm.

Whereas the rate cuts had been designed to quiet the hostile political climate, the second phase of SB 14, which moved the state to file and use rate regulation, was an attempt — at least by some policymakers — to bring long-term deregulation to the market. File and use became law in December 2004, and has the potential for creating a regulatory climate that would allow companies the flexibility to use rates with limited government interference. However, absent clear statutory direction to this end, the frequent use by the commissioner of his ability to subsequently disapprove rates could lead to a highly regulated market.

The Policy Debate in 2005

The debate over homeowners’ insurance rates continues in 2005. However, the marketplace is significantly healthier than in the past, showing signs of increased profitability and competition. The potential of long-term deregulation of rates from the passage of SB 14 appears to have attracted new insurers and encouraged companies already in Texas to expand their capital investment.

For 2004, the industry’s average loss ratio was 27.6 percent, which is considered very good. And the so-called Herfindahl Index, the scale economists use to measure market concentration, has declined each of the last five years (Brockett and Arnold). The U.S. Department of Justice classifies any score under 1,000 as unconcentrated. A score of 10,000 represents a monopoly. The 2003 level of 1388.108 shows the Texas market to be workably competitive.

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

YEAR	INDEX
1998	1662.736
1999	1661.498
2000	1636.312
2001	1611.086
2002	1458.875
2003	1388.108

Source: Brocket and Arnold

However, several bills have been filed in the 79th Texas Legislature that would have significant negative impacts on the health of this market.

Two bills, SB 14 by Sen. Jackson, and HB 1585 by Rep. Smithee, would impose significant new regulations on the industry. One provision would subject to prior approval rate filings from any company that was appealing a prior disapproval by the insurance commissioner. Another provision would allow the commissioner to order penalties and restitution from companies to consumers anytime he disapproves a rate filing. SB 14 passed the Texas Senate on a 31-0 vote, and will likely be heard by the House Insurance Committee.

These two bills, if passed, would completely undo the deregulatory reforms introduced by the 78th Legislature and would make the entire market behave as if it were subject to prior approval. Any company that exercised its rights to appeal a commissioner's rate finding would officially be subject to prior approval. And more significantly, no company would want to risk the possibility that a commissioner could confiscate prior earnings months, or years, after a rate has been put in place. Companies would seek some type of informal assurance from the commissioner that their rates were deemed compliant with state law prior to any rate filing. Thus the benefits of the file and use system would be eliminated only a few months after the system was implemented.

Additionally, numerous other bills have been filed that would limit or prohibit the use of credit scoring in rate setting. Several interest groups and state legislators are pushing for this legislation despite the findings in a TDI report that credit scoring is correlated to risk and it enables an insurer to more accurately predict losses when used in conjunction with other information.

Regulatory actions by TDI have also been a part of the policy debate of 2005. On March 16, TDI ordered most of the state's homeowners' insurance groups to file and justify their rates. The order was seemingly motivated by the reports of the industry's low average loss ratio. The filings were due to the department by May 1. In issuing the order, Insurance Commissioner Jose Montemayer said, "Every year poses a new set of risks, and we know that hurricanes and hailstorms will happen again in Texas. Nonetheless, if insurers are benefiting from improved trends, we expect Texas policyholders to benefit, as well" (Texas Department of Insurance News Release).

Conclusions

There is no doubt that the regulation of homeowners' insurance needed changing in 2002-03. TDI acknowledged that mandating of insurance coverage had driven up rates. And, as previously mentioned, a regulatory scheme that provided homeowners' insurance largely through a loophole was not conducive to the commitment of long-term capital needed to address the insurance needs of Texans.

However, many policymakers seeking to remedy the situation have not focused primarily on the faulty laws and regulations. Instead, the focus has too often been on insurance companies, the high premiums they were charging and how to get immediate relief for consumers.

This is true despite the fact that policymakers have had ample evidence available that 1) the high rates were largely being driven by questionable medical and legal claims about mold, and the accompanying media coverage, 2) the industry was being hit by large losses, and 3) rates had stabilized and were even beginning to drop by the beginning of 2003.

The legislative and regulatory actions taken over time that have sought to force insurance rates lower have largely been premised on three assumptions made by staff at TDI (Texas Department of Insurance SB 310 Report). They are:

- companies have made assumptions of future losses that are too high;
- companies have sought excessive profits; and
- companies have underestimated the reduction in risk brought about by regulatory changes in coverage.

Another way of putting this is that insurance companies have been blamed for overcharging consumers because the actuaries and officials at TDI claim that the actuaries and officials at most of the major insurance companies in Texas are wrong. They are wrong, according to this criteria, because they are either too risk averse, i.e., being overly protective of their capital, or too greedy, i.e., seeking too great of a return on their capital.

This view is corroborated by a finding of the Property and Casualty Insurance Legislative Oversight Committee. In its Interim Report to the 79th Texas Legislature, the committee summarized the conclusions from TDI's SB 310 report: "The sum of these conclusions indicates under-pricing prior to 2002, and a subsequent overcorrection on the part of the industry as a whole."

In other words, actuaries and officials at TDI claim that for the last five years or so, in good times and bad, the entire homeowners' insurance industry in Texas has been incapable of pricing its products correctly. Policymakers and interest groups who have supported increased regulation have also, to some degree, embraced this claim.

This clash between politicians and the owners (and beneficiaries) of capital is one of the main focuses of public choice theory. According to the theory, "Although legislators are expected to pursue the 'public interest,' they make decisions on how to use other people's resources, not their own. … Politicians may intend to spend taxpayer money wisely. Efficient decisions, however, will neither save their own money nor give them any proportion of the wealth they save for citizens" (Jane S. Shaw).

Policymakers have little incentive to make wise or efficient decisions about the money belonging to their constituents, who in this case, are the consumers of homeowners' insurance and the shareholders in insurance companies. In fact, Shaw writes that public choice theory holds that the incentives are usually skewed in the opposite direction:

> There is no direct reward for fighting powerful interest groups in order to confer benefits on a public that is not even aware of the benefits or of who conferred them. Thus, the incentives for good management in the public interest are weak. In contrast, interest groups are organized by people with very strong gains to be made from governmental action.

In the battle over homeowners' insurance, the powerful interest groups that policymakers sought to satisfy were not insurance companies, but consumer groups, newspapers, political opponents and others who purport to protect citizens and consumers by supporting government interference in the free market. Many of these interest groups wanted not only lower rates for consumers, but also lower profits for the insurance companies that had "hurt Texas families."

This is not to say that all legislators who favored increased regulations were pandering to special interests or out to get insurance companies. Some, as has been shown, believed that the market could not handle the crisis and that they had to step in. Nevertheless, the political pressures were significant, and even many of those who had faith in the market may not have believed that they could afford to take the political risk of trusting in market forces.

The same process is at work today. Because two of the largest insurance companies initially challenged increased regulations, with one challenge still being pursued, a significant portion of the highly publicized mandated rate decreases have not taken effect. Thus policymakers have strong incentives to compel compliance. Additionally, the recent report of low loss ratios again raises the specter of insurance companies profiting at the expense of their customers.

The policymakers who are now seeking to re-regulate the industry and/or mandate rate decreases ignore two facts. First, insurers suffered heavy losses for three consecutive years. Yet policymakers were not forcing the companies to raise rates then in order to assure a certain level of profitability. Second, and most important, according to Brockett and Arnold, "the Texas homeowners' market can be judged as workably competitive." Texas consumers have a choice in where they purchase their homeowners' insurance – they don't need to be protected by policymakers in Austin.

If the efforts to undermine the benefits of a properly implemented file and use system are successful, Texans may once again find themselves paying the highest insurance premiums in the nation. The evidence in Texas is clear; allowing the marketplace to set prices is the best way to ensure Texans have a wide choice of insurance plans at the best prices.

Recommendations:

- Texas policymakers should not undo last session's reforms through new regulations, such as prior approval, retroactive restitution, credit scoring or mandated rate cuts; this will adversely affect Texas consumers;

- The Texas Legislature should codify terms to ensure a true, least-regulatory form of file and use that allows competitive pricing to determine the cost of insurance premiums; and

- The Texas Department of Insurance should focus on regulating solvency, market conduct and forms, not prices.

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The Center for Economic Freedom was established by the Texas Public Policy Foundation to champion economic freedom in Texas by providing policymakers with reliable information and practical market-based alternatives to state regulation of transactions between businesses, employees, and consumers.

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