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Unintended Consequences: Regulation of Policy Forms and the Mold Crisis

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It is generally assumed that any costs imposed by regulations are more than offset by the benefits they confer upon consumers. But this ignores the unintended consequences that these attempts to modify economic behavior have on the economy. As economist Arthur Laffer explains:

> Just like with the laws of physics, economic laws are simply descriptions of reality. Scarcity can no more be ignored than gravity. Policymakers who think they can determine the proper price of a good better than the market will create no less a disaster than the captain of an ocean liner who believes his engines will allow him to pay no heed to momentum.
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> Economic laws cannot be broken—only ignored. Attempts to do so leave a convoluted trail of unintended consequences harming people who don't understand what went wrong or who caused the problem.[1]

A perfect example of the unintended consequences of governmental economic intervention is the regulation of policy forms* in Texas, which wound up costing Texans almost $900 million.

In 1997, the Texas Legislature passed SB 1449, which allowed the commissioner of insurance to "adopt policy forms and endorsements of national insurers or policy forms and endorsements adopted by a national organization of insurance companies or similar organization on policy forms and endorsements" in place of state-promulgated forms and endorsements. However, TDI did not adopt any national policy forms under this provision until 2002.

In the meantime, the Texas mold crisis began to unfold following a 1999 lawsuit that resulted in a court finding that TDI's standard form required insurers to cover mold claims. With companies unable to use national forms, mold claims under the state-mandated form grew from 1,050 in the first quarter of 2000 to 14,706 in the fourth quarter of 2001. The average cost of mold claims per policyholder per year increased from $24.32 in 1999 to $300.50 at the end of 2001, having peaked in the third quarter at $444.35. From 2000 to 2003, companies writing homeowners' policies in the state shrank from 137 to 101.

Consequently, premiums rapidly increased, though not nearly as fast as claims. In 2001-02, premiums increased over 40 percent. All Texas homeowners had to pay higher rates, and many were forced into the residual market because of a lack of availability.

All of this was due to three things: 1) incorrect judicial interpretation of the standard homeowners' form, 2) a feeding frenzy of lawsuit abuse following the first lawsuit, and, ultimately, 3) TDI's belated implementation of SB 1449.

Conventional wisdom has the "mold crisis" coming to an end after the Legislature rewrote insurance laws in 2003, but the facts show the mold crisis began to come to an end in 2002, when TDI finally allowed companies to begin using national forms.

An August 2002 article in *The Dallas Morning News* featured the headline, "Home insurance up, but not much. Rates have stabilized since May, stay above state standard in area." TDI also reported to the 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."[2]

In fact, mold claims plummeted in 2003, well before the legislative reforms took effect, and for the first time in four

* Policy forms spell out the coverage provided by the insurance policy. Forms can be regulated for both content, i.e., the insurable events covered by the policy, and clarity.

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Table 1: Monetary Impact of Forms Regulation on Texas Homeowners' Premiums, 2001-2005[3]

Year	Texas Avg. Premium	% Increase	US Avg. Premium	% Increase	Texas to US ratio	Texas Total Premiums	$ Increase	% Increase	$ Revised Increase	Texas Adjusted Base	Form-Regulation Cost
1997	$855		$455		1.88	$2,468,086,626				$2,468,086,626	N/A
1998	$879	2.81%	$481	5.71%	1.83	$2,633,703,160	$165,616,534	6.71%	$337,147,944	$2,805,234,570	N/A
1999	$861	-2.05%	$487	1.25%	1.77	$2,804,336,380	$170,633,220	6.48%	-$103,940,818	$2,701,293,752	N/A
2000	$880	2.21%	$508	4.31%	1.73	$2,907,168,495	$102,832,115	3.67%	$200,941,043	$2,907,258,321	N/A
2001	$955	8.52%	$536	5.51%	1.78	$3,121,726,707	$214,558,212	7.38%	$138,758,907	$3,046,017,228	$75,709,479
2002	$1,238	29.63%	$593	10.63%	2.09	$3,802,852,983	$681,126,276	21.82%	$436,696,204	$3,483,150,128	$319,702,855
2003	$1,328	7.27%	$668	12.65%	1.99	$4,324,626,880	$521,773,897	13.72%	$646,322,788	$4,123,009,688	$201,617,192
2004	$1,363	2.60%	$729	9.13%	1.87	$4,361,635,314	$37,008,434	0.86%	$38,120,762	$4,161,549,779	$200,085,535
2005	$1,372	0.70%	$764	4.80%	1.80	$4,610,859,573	$249,224,259	5.71%	$347,574,525	$4,508,776,729	$102,082,844
Total											**$899,197,905**

Sources: National Association of Insurance Commissioners; *TDI Insight*, Texas Department of Insurance.

years, premiums collected exceeded losses and costs, if only slightly. Premiums for individual policies also began to stabilize. TDI estimated that the 2002 changes in mandated coverage saved consumers an average of 13.5 percent on a theoretical policy with a premium of $1,000.

Though it is clear that abuse of the legal system was the mechanism that drove the skyrocketing costs during the mold crisis, the damage done by this would have been lessened or perhaps even avoided if TDI had implemented SB 1449 in a timely manner.

To isolate the effect that insurance-form regulation had on Texas premium increases during the mold crisis, **Table 1** compares premium increases in Texas to U.S. premium increases and then determines what the premium levels in Texas would have been if Texas had simply matched the rate of increase in national premiums.

Table 1 reveals that the overregulation of forms from 2001 to 2005—in an attempt to protect consumers—actually cost consumers more than $899 million dollars in increased premiums. No one knows what might have occurred in the absence of regulation, but it is highly unlikely that TDI regulation protected consumers from actions by insurers that would have cost $899 million. Even if consumers had suffered such harm in the absence of regulations, they would have been able to seek redress for the damages through TDI and the courts. In the case of the damages caused by forms regulation, the money is gone forever.

The reasoning behind regulating forms was that TDI could negotiate of behalf of individual consumers who on their own lacked the resources and sophistication to deal successfully with large insurance companies. But in fact, TDI became much more than a third party to the contract negotiations between consumers and insurance companies—it could impose its will on both parties whether they liked it or not. And, as the research shows, consumers subsequently suffered almost $900 million worth of harm from the very regulations that were intended to help them.

The unintended consequences of "consumer protection" regulations still increase the cost of homeowners' insurance in Texas today. That is why it is important to use the Sunset process to reduce insurance regulation. Our complete study on this, *Consumers, Competition, and Homeowners' Insurance*, is available at www.TexasPolicy.com.

ENDNOTES

[1] Arthur Laffer, "Violate at Your Own Risk: The Immutability of Economic Laws," *Thinking Economically Lesson 1*, Texas Public Policy Foundation, January 2008.

[2] http://www.tdi.state.tx.us/pubs/insight/200305.pdf.

[3] The findings of Table 1 are adjusted using the difference between gross national product and Texas' gross state product to account for differences in national versus state economic growth.

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