TEXAS PUBLIC POLICY FOUNDATION

Testimony

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Center for Economic Freedom

Budget Recommendations on TDI and OPIC

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Recommendations

- Eliminate the Office of Public Insurance Counsel and its functions, along with several TDI functions that feature pre-market regulatory activities, so that consumer-protection efforts are dealt with through complaints and enforcement functions.
- Change Goal A in TDI's appropriations bill pattern from "Encourage Fair Competition" to "Encourage Competition."

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During the interim, the Texas Public Policy Foundation undertook a sunset review of both of the Texas Department of Insurance and the Office of Public Insurance Counsel. This was done in concert with their review by the Texas Sunset Advisory Commission. Our review was a strategic analysis seeking to benefit consumers and taxpayers through improved market operations and streamlined regulation when it comes to homeowners insurance. The following are our findings related to the budget and strategic planning of these two agencies.

ISSUE: The Governance of Both TDI and OPIC, as Reflected in Statute, Rules, Agency Policies, and the Appropriations Process, is Not Always Aligned with the Best Interests of Consumers.

TPPF Recommendations

- **1.1** Eliminate the Office of Public Insurance Counsel and its functions, along with several TDI functions that feature pre-market regulatory activities, so that consumer-protection efforts are dealt with through complaints and enforcement functions.

- **1.2** Change Goal A in TDI's appropriations bill pattern from "Encourage Fair Competition" to "Encourage Competition."

Key Findings

- TDI's and OPIC's efforts at consumer protection often divert resources away from—and at times conflict with—maintaining availability of affordable insurance through a competitive marketplace.
- TDI's first goal in its appropriations bill to "Encourage Fair Competition" conflicts with statutory guidance to promote competition and insurance availability and creates an overly broad mission for TDI.

Analysis

The governance of both TDI and OPIC, as reflected in statute, rules, agency policies, and the appropriations process is too often targeted at competitive behavior between/among companies, rather than the behaviors of companies toward consumers. Its governance is also too heavily weighted toward pre-market regulation rather than post-market regulation. These aspects have two negative impacts.

First, competition is restricted, and consumer choice is restricted. Markets are less efficient, prices tend to rise, and innovations are stifled.

Second, valuable agency resources are redirected away from protecting consumers and helping those who have been harmed.

The recommendations in this testimony are designed to shift the governance of TDI toward a more consumer-friendly regulatory approach. This approach also results in a reduction in the funds needed by TDI for regulation—funds paid for by consumers through assessments on insurance companies.

The Staff Report recommends—and rightly so—that OPIC be eliminated. However, this recommendation would not eliminate most of the functions of OPIC but would simply transfer OPIC's activities and budget to TDI.

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This recommendation is made to "enhance the consumer perspective in the Department's overall regulation of insurance by bringing consumer representation inside the Department's review processes and consumer protection activities."

This idea is laudable, but it misses the point. Rather than inject a consumer representative into the regulatory process, the goal should be to reform the regulatory process, so that it is entirely consumer-focused.

In his paper examining the Texas electric market, Robert Michaels observed that the success of Texas' deregulation was based on the fact that "Texas did not 'design' a retail market in any meaningful sense—it instead set general rules for retail electric providers … and allowed them to compete as they wished within those rules. The details of what would be sold and how it would be priced were left to the ingenuity of buyers and sellers."

The current governance structure of TDI (and OPIC) is geared too much toward designing the insurance market and restricting competition, rather than setting general rules that allow companies to compete within those rules. Moving most of the functions of OPIC to TDI does nothing to change this imbalance.

Fortunately, programs exist within TDI that can be used as the basis for shifting the governance of TDI. TDI's first goal is "Encourage Fair Competition in the Insurance Industry" (more about this later). The second objective under this goal is "Reduce Unfair and Illegal Insurer Practices."

It is generally the programs funded under this objective that provide the ability to shift TDI's governance structure away from excessive interference with competition. These programs include complaint resolution and investigating/prosecuting illegal and fraudulent activities. TDI devotes approximately \$6.8 million and 125 FTEs to these efforts. Efficiencies in these programs over the recent years—in part due to technological advances—should allow these programs to handle this shift without any additional appropriations.

TPPF Recommendation 1.1.a: Eliminate the Office of Public Insurance Counsel and its functions so that consumer protection efforts are dealt with through complaints and enforcement functions (Annual Savings: \$1.044 million; 16.5 FTEs).

The mission of OPIC "is to represent the interests of consumers in insurance matters. This means advocating fairness and stability in insurance rates and coverage; promoting public understanding of insurance matters; working to make the overall insurance market more responsive to consumers; and ensuring consumers receive the services they have purchased."

The Staff Report on OPIC recommends that the Legislature "Abolish the Office of Public Insurance Counsel and create a Consumer Representative within the Department of Insurance."

As mentioned above, rather than inject a consumer representative into the regulatory process, the goal should be to reform the regulatory process so that it is entirely consumer-focused. The recommendations in the Foundation's Sunset report on TDI are designed with this end in mind and, thus, eliminate the need for OPIC or a "consumer representative" within TDI. To the extent there are any consumer-education functions of OPIC that TDI wishes to take up, they can be absorbed within TDI's existing programs.

TPPF Recommendation 1.1.b: Eliminate TDI's Consumer Protection – Advertising Unit (Annual Savings: \$284,000; 6 FTEs).

The Advertising Unit "protects the public and promotes accuracy in advertising by reviewing insurance advertisements. … These reviews ensure that companies are not inappropriately using unfiled required ads on their websites and also help detect potentially false and misleading statements."

This program is a perfect example of a pre-market function mentioned in the Staff Report. While it is designed to protect consumers, it hinders innovation and competition. In 2006, the average review of an advertisement was 23.8 days, so companies develop their products and advertisements and must wait (in the case of required ads) the better part of a month before they can actually use them.

A better approach is to move the review of advertisements to a complaint-and-enforcement-driven process. If customers complain or TDI employees have reason to suspect a problem with advertisements, TDI's complaint and enforcement programs can readily handle the process.

TPPF Recommendation 1.1.c: Reduce the size of TDI's Property and Casualty – Personal and Commercial Lines Division (Annual Savings: $800,000; 17 FTEs).

The Personal and Commercial Lines Division supports "the mission of the Property & Casualty Program through reviewing insurance products and assisting consumers." Specifically, it "reviews individual insurer filings of forms, endorsements, and rules for compliance with statutory and/or rule requirements and verifies that they do not contain provisions, titles, or headings which are unjust, encourage misrepresentation, are deceptive, or violate public policy." It does this for both private insurers and statutorily-created entities, such as the Texas Windstorm Insurance Association (TWIA).

The recommendations in the Foundation's Sunset report on TDI would significantly reduce insurance-form regulation and, thus, the workload for the Personal and Commercial Lines Division, while this recommendation would reduce the budget and FTE count of the division by 50 percent.

TPPF Recommendation 1.1.d: Reduce the size of TDI's Property and Casualty – Actuarial Division (Annual Savings: $250,000; 4 FTEs).

The Property and Casualty Actuarial Division "provides actuarial review of rate and rating plan filings to ensure rates and premiums are just, fair, reasonable, adequate, not confiscatory, not excessive and not unfairly discriminatory for the risks to which they apply."

Again, our Sunset recommendations would reduce the review of rate filings in the Property and Casualty Division, decreasing the need for actuarial support. Thus, we recommend that the budget and FTEs be reduced by 25 percent.

Our recommendations may also reduce the need for actuaries in the Property and Casualty Division by more than the 4 FTEs mentioned above. If this is the case, these actuaries could be transferred to the Actuarial Division in the Financial Program, to improve TDI's focus on company solvency.

The recommendations above represent annual savings of $1.58 million and a reduction of 39 FTEs. This is about 1.5 percent of TDI's total budget. Though this may have only a small (yet beneficial) direct impact on consumers' wallets, these recommendations will have a much larger long-term impact, as competition yields efficiency gains and innovations in the market, brings new capital to the Texas homeowners' insurance market, improves products, and lowers prices.

Some will object to these recommendations, saying the state should devote more—not fewer—resources to pre-market regulatory activities. There are two responses to this objection.

First, as has been noted, the marketplace is more focused on consumer interests than are regulators. A healthy, competitive market will foster efficient pricing that, in the long run, will result in the lowest prices possible that still support the innovations needed to meet consumer demand. Even those who have called for heavier insurance regulation have acknowledged these and other benefits of a competitive market—they just (mistakenly) believe the insurance market is not competitive enough. The proposals made here do not reduce the amount of resources devoted to preventing undesirable behavior. In fact, they increase the amount. Reducing impediments to competitive behavior increases the oversight of market behavior by companies, quality assurance organizations, the media, consumer groups, and consumers themselves.

The second response is that pre-market efforts to prevent undesirable behavior disrupt competition and impose heavy costs on consumers and the economy. In most cases, it is difficult to determine what these costs are and what consumers have lost, due to the lack of innovation—this involves imagining proving what might have happened had the regulations not been imposed. But in the case of the Texas mold crisis, the costs of market-disrupting regulations can be quantified.

Research reveals that, from 2001 to 2005, the overregulation of forms—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 this pre-market regulation, but it is highly unlikely that form regulation protected consumers from actions by insurers that would have cost $899 million. Even if consumers had suffered harm, they would have been able to seek redress for damages through TDI and the courts for any illegal behavior by insurers. In the case of the damage caused by form regulation, the money is gone forever.

Our recommendations are designed to avoid the unintended but costly consequences of ill-advised pre-market regulations. Additionally, the freeing up of resources would provide TDI with more resources to assist consumers in addressing problems through post-market regulatory activity.

TPPF Recommendation 1.2: Change Goal 1 in TDI's budget structure, etc. from "Encourage Fair Competition" to "Encourage Competition."

Goal 1 under TDI's budget structure is "Encourage fair competition in the insurance industry." However, TDI is required by statute to "promote price competition," not to "encourage fair competition." While fairness is certainly contemplated in the statute, it is focused not on competition but on the prohibition of "unfairly discriminatory rates." A focus on fair competition undermines price competition and TDI's statutory mandates to focus on availability of insurance and solvency of rates.

This happens in two ways.

First, the operation of the marketplace is negatively impacted. Fair competition has been interpreted in Texas (though to a lesser extent than in many other jurisdictions) to mean that companies should not be able to price policies based on risk. Texas avoided overstepping its bounds here, when it came to credit scoring (also related to the prohibition on discriminatory rates), but it is very much in play regarding windstorm insurance, where TWIA is prohibited by statute from pricing based on proximity of the property to areas more subject to wind damage.

Fair competition standards also call into question company determinations of needed return on capital. Insurers have a responsibility to shareholders, policyholders, and taxpayers to earn returns that allow companies to attract the capital needed to stay in business, maintain profitability, and pay off future claims. Actuaries—whether at TDI or an insurer—are inappropriate determiners of what rate of return is acceptable to capital markets. Companies not allowed to price for risk or future capital needs will be unwilling and unable to be fully competitive on prices—at least without risking insolvency.

Second, a focus on fair competition undermines TDI's ability to carry out its functions properly. Under Goal 1, there are two objectives and seven strategies, as follows:

Objective 1.1 Encourage fair competition in the insurance industry by reducing impediments to competition and improving insurance availability.

- Strategy 1.1.1. Analyze market data and provide information to consumers and industry.
- Strategy 1.1.2. Process rates, forms and licenses.
- Strategy 1.1.3. Create incentives and requirements for coverage in underserved markets.

Objective 2.2 Encourage fair competition in the insurance industry by reducing unfair and illegal practices.

- Strategy 1.2.1. Respond promptly to complaints against insurers, agents, and other regulated entities.
- Strategy 1.2.2. Investigate apparent patterns of unlawful or questionable trade practices in the insurance industry; and bring enforcement actions as appropriate.
- Strategy 1.2.3. Investigate potential insurer fraud and initiate legal action when appropriate.
- Strategy 1.2.4. Texas On-line.

Funding for these objectives and strategies totals about $22 million per year—or about one-third of TDI's budget, minus workers' compensation—so the impact on the agency's operations is significant.

TDI's Self-Evaluation Report shows the extent of these objectives' impact on the agency. Objectives 1.1 and 1.2 impact all of the agency's functions:

- Licensing, certification, and registration
- Form, rate, and advertising review
- Examination, monitoring, and solvency review
- Research and analysis
- Education, outreach, and customer assistance
- Complaint and dispute resolution
- Enforcement, fraud, and investigations

For the most part, TDI's programs under Objective 2.2 put the emphasis on fairness in the right place: on unfair and illegal practices. It is the programs under Objective 1.1 that tend to impact competition most negatively.

This is interesting, because the Output Measures for Objective 1.1 shows an understanding that it is the regulatory structure that serves as the greatest impediment to competition. So the measures include: "Percent of company … licenses completed within 60 days," "Percent of statutory rate and form filings completed within 90 days," etc. Yet the operations of the programs are too often focused on the competitive behavior in the market, rather than on improving the efficiency and effectiveness of the programs themselves.

One example of this is the Outcome Measure under Objective 1.1, "Percent of statutory rate and form filings completed within 90 days." The agency is expected to complete 87 percent of the filings within this time. However, this performance measure does not reveal that two rate cases were, until last month, outstanding for several years, together accounting for approximately 45 percent of the market. One of these rate cases, against Allstate, was recently settled.

Of course, TDI is only one party in such litigation. At the least, TDI's Outcome Measure should be changed to reflect the market share of rate filings, instead of the percent of rate filings themselves, to give a better account of the regulatory impact on filings. But the fact that nearly fifty percent of the market was hampered by these rate cases provides strong evidence of TDI's over-emphasis on fairness.

A better application of TDI's statutory mandates would change Goal 1 to read: "Encourage competition in the insurance industry." Allowing consumers and capital markets to determine the appropriateness of a rate is the best approach. And this is a self-correcting mechanism, where companies will adjust their rates to meet market conditions.

Sunset Advisory Commission Recommendations

- Abolish the Office of Public Insurance Counsel and create a Consumer Representative within the Department of Insurance.
- Transfer the Public Counsel's statutory board positions and nomination duties to the Consumer Representative at TDI.
- Transfer the responsibility for OPIC's consumer publications to TDI.
- Transfer the authority to assess insurers to pay for consumer representation from OPIC to TDI.

These recommendations are made to "enhance the consumer perspective in the Department's overall regulation of insurance by bringing consumer representation inside the Department's review processes and consumer protection activities."

However, as noted above, this idea is laudable, but it misses the point. Rather than injecting a consumer representative into the regulatory process, the goal should be reforming the regulatory process so that it is entirely consumer-focused. The recommendations in the Foundation's Sunset report on TDI are designed with this goal in mind and, thus, eliminate the need for OPIC or a "consumer representative" within TDI. ✯

About the Author

Bill Peacock is the vice president of administration and director of the Texas Public Policy Foundation's Center for Economic Freedom. He has been with the Foundation since February 2005.

Bill has extensive experience in Texas government and policy on a variety of issues, including economic and regulatory policy, natural resources, public finance, and public education. His work has focused on identifying and reducing the harmful effects of regulations on the economy, businesses, and consumers.

Prior to joining the Foundation, Bill served as the Deputy Commissioner for Coastal Resources for Commissioner Jerry Patterson at the Texas General Land Office. Before he worked at the GLO, Bill was a legislative and media consultant. He has also served as the Deputy Assistant Commissioner for Intergovernmental Affairs for then-Commissioner Rick Perry at the Texas Department of Agriculture and as a legislative aide to then-State Rep. John Culberson.

Bill began his career in state policy in 1989 in the Texas Senate as the analyst for public education and school finance for the Senate Education Committee.

Bill has a B.A. in History from the University of Northern Colorado and a M.B.A. with an emphasis in public finance from the University of Houston.

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