TEXAS PUBLIC POLICY FOUNDATION

March 2009
*Center for Economic Freedom*

# Rate Regulation of Homeowners' Insurance

by Bill Peacock
Director, Center for Economic Freedom

## Recommendations

- Shift the focus of homeowners' insurance rate regulation to rates that are inadequate or discriminatory by striking "excessive" from Section 2251.001(1), Insurance Code.
- Make the insurance system a true file-and-use system by repealing Section 2251.103, Insurance Code.
- Allow the commissioner to place under prior approval only those companies whose financial positions warrant increased supervision for the purposes of maintaining solvency.

900 Congress Avenue
Suite 400
Austin, TX 78701
(512) 472-2700 Phone
(512) 472-2728 Fax
www.TexasPolicy.com

PP09-2009

## Issue

Incomplete implementation of file-and-use rate regulation and conflicting statutory guidance on rate regulation create regulatory uncertainty, disrupt competition, and lessen insurance availability in the Texas homeowners' insurance market.

## TPPF Recommendations

1. Shift the focus of homeowners' insurance rate regulation to rates that are inadequate or discriminatory by striking "excessive" from Section 2251.001(1), Insurance Code.

2. Make the insurance system a true file-and-use system by repealing Section 2251.103, Insurance Code, so the commissioner would be able to disapprove only those rates that are already in use.

3. Allow the commissioner to place under prior approval only those companies whose financial positions warrant increased supervision for the purposes of maintaining solvency by

   a. striking "or rating practices" from Section 2251.151(a)(1), Insurance Code, and

   b. repealing Section 2251.151(a)(2), Insurance Code.

## Key Findings

- Positive results are being realized in insurance markets embracing competition, including Texas.

- The overregulation of homeowners' insurance in Texas produces poor results for consumers, such as swings in price and availability. Ultimately, a regulatory stance focused on affordability reduces investment and hinders competition in the Texas insurance marketplace and puts insurers at risk of insolvency.

## Analysis

Approaching insurance markets from a competitive perspective is not limited to economic theories and models. Deregulation of other Texas industries—namely electricity and telecommunications—has been a success in increasing consumer choice and competition. Illinois, South Carolina, and Washington, D.C., have reduced regulations in insurance markets and, as a result, have seen more market participants, lower/more stable premiums, and shrinking residual markets.

For example, since 1971 Illinois has followed a competition-based insurance market for personal lines, such as auto and homeowners' insurance. Due to the size of the state and length of time it has operated without price controls, Illinois provides an excellent case to examine the benefits or problems with this approach. A study comparing Illinois' auto insurance market to comparable states found Illinois to have "less variable loss ratios and rate levels, lower consumer prices, the highest number of insurance carriers in the nation, and a low number of uninsured drivers." The automobile residual market in Illinois also routinely ranks well below the national average. The Herfindahl Index for homeowner's insurance in Illinois has remained stable and low from 2000 through 2004. Illinois homeowners face weather similar in severity and variety to Texas yet have been able to sustain a healthy market

*continued on next page*

without regulation. All signs from the Illinois insurance industry point to a healthy and thriving marketplace that benefits consumers.

In South Carolina, an auto-insurance-availability crisis erupted after years of rate suppression and regulation, whereby insurance companies chose to exit the market rather than deal with the state's heavy-handed oversight. The residual market reached 40 percent of insured drivers, while the pool of sellers shrank. In 1997, the South Carolina Legislature passed sweeping reforms that deregulated auto insurance and increased competition. South Carolina's reliance on competition to help the auto insurance industry resulted in the doubling of the number of insurers writing policies, a steadying of rates, and a residual market pool that decreased rapidly.

The District of Columbia experienced a similar auto insurance crisis. Following free-market reforms passed in 1996, D.C. also had insurance providers return to the market, while premiums declined, and the residual market decreased by 80 percent.

Positive results are being realized in insurance markets embracing competition. The same success could be achieved by reducing regulation in the Texas insurance marketplace.

TPPF recommends three courses of actions the Texas Legislature could take to clarify statutory guidance.

***TPPF Recommendation 1: Shift the focus of homeowners' insurance rate regulation to rates that are inadequate or discriminatory by striking "excessive" from Section 2251.001(1), Insurance Code.***

Historically, the primary basis for rate regulation for personal lines of insurance, such as auto and homeowners' insurance, was to ensure company solvency. Today, the focus in Texas and elsewhere seems to be on the concept of affordability, which is both relative and subjective. What is affordable for one consumer may not be affordable for another. There can be no actuarially-sound rate that is affordable for everyone. The subjectivity of pursuing affordability leads to regulatory uncertainty for insurers and shifts resources away from solvency and risk.

Rate regulation focused on affordability disrupts consumer choice and results in inefficient and anti-competitive pricing. The pursuit of affordability in Texas has led to a focus on preventing excessive rates. The Code says rates may not be "excessive." However, this statutory emphasis on excessive rates conflicts with other statutory provisions that 1) prohibit "inadequate" rates, 2) "promote the availability of insurance," and 3) "promote price competition among insurers." The overemphasis on low rates has been found to be "wasteful, produce higher industry costs, delay innovation, reduce competition, slow the introduction of new products to the market, and build operational inefficiencies into businesses that are regulated."

The regulation of homeowners' insurance in Texas produces poor results for consumers, such as swings in price and availability. Ultimately, a regulatory stance focused on affordability reduces investment and hinders competition in the Texas insurance marketplace. Insurers assess risk years into the future, but today they can't even predict what their income will be next year.

***TPPF Recommendation 2: Make the insurance system a true file-and-use system by repealing Section 2251.103, Insurance Code, so the commissioner would be able to disapprove only those rates that are already in use.***

Repealing Section 2251.103 would allow the commissioner to reject only rates already in use, per Section 2251.104. As a result, rates would reach the market sooner, and price competition and insurance availability would increase.

Thus, after repealing Section 2251.103, the only way a rate would be rejected is by an order from the commissioner issued no later than 15 days after an administrative hearing (of which the relevant insurer has 20 days' written notice from the commissioner), specifying "in what respects the rate fails to meet the requirements" of Chapter 2251 of the Code.

The commissioner's reviewing rates prior to their use—and the corresponding ability to accept or reject rates prior to their use—has kept the Texas insurance market from being a true file-and-use system.

Eliminating the ability to disapprove rates prior to their being used would remove regulatory impediments to true competition in the insurance industry, and consumers and capital markets would determine the appropriateness of rates.

***TPPF Recommendation 3: Allow the commissioner to place under prior approval only those companies***

***whose financial positions warrant increased supervision for the purposes of maintaining solvency by striking "or rating practices" from Section 2251.151(a)(1), Insurance Code, and repeal Section 2251.151(a)(2), Insurance Code.***

Until last year, because State Farm and Allstate—the state's largest and second-largest writers of property and casualty (P&C) insurance, respectively—operated under a prior-approval regime, almost half of Texas' P&C market was adversely affected by the over-emphasis on excessive rates. Now that TDI, Allstate, and Farmers have ended their legal battles, no major insurers are operating in Texas under prior approval. But this doesn't change the fact that the market had been hampered by this battle over rates for almost five years.

As noted above, the Staff Report states, "Fifty-two new companies have had policy forms approved and approximately 29 companies have begun writing insurance. In 2006, these new companies combined to comprise 3.7 percent of the total homeowners' market."

While the reforms of 2003 have brought new entrants, only about half of the companies that have filed forms have actually offered rates through them, and of those that entered the market, they claimed only 3.7 percent of the market share in 2006.

One strong possibility for this is that these potential or actual new entrants are still hesitant to commit capital to Texas given the lack of full implementation of the file-and-use system they were promised.

The Foundation's recommendation would limit the reach of prior approval to those insurers at imminent risk of insolvency, thus protecting to the extent possible these companies' ratepayers, while restoring a capital-friendly regulatory certainty to the marketplace.

Quite distinct from attempting to protect consumers whose insurers are at great risk of insolvency, placing an insurer under prior approval for how that insurer calculates rates—what factors the insurer considers and does not consider, how those factors are weighted, etc.—is the type of subjective pre-market response identified by Sunset Commission staff.

Additionally, it is difficult to see how "a statewide insurance emergency" justifies placing a company (or companies) under prior approval. Without a clear definition of what constitutes "a statewide insurance emergency," this section of the Code provides the commissioner a catch-all provision to justify placing any insurer(s) under prior approval. This vague statutory language does not provide the commissioner or insurers with clear guidance on the implementation of prior approval and has the potential to be the exception that swallows the rule.

This recommendation will end the Code's subjective justifications for placing an insurer under prior approval, leaving imminent risk of insolvency as the only reason a company may be placed under prior approval by the commissioner. The results for TDI will be more time and money available for other responsibilities. The results for the market will be timelier rates, lower regulatory costs for insurers, and cost savings to consumers.

## Sunset Advisory Commission Recommendations

***Set limits for the amount of time the Department has to review and administratively disapprove filings under the file-and-use system.***

If implemented, this recommendation will not remedy the main problem facing the Texas P&C insurance market: the commissioner would still have the statutory authority to disapprove filed rates before they are used, and a true file-and-use system would not exist.

Setting a time limit for the commissioner to review and approve/disapprove rate filings would put the commissioner on a review-and-decision timetable, but companies would still face the regulatory uncertainty that comes with a system whereby the commissioner has the authority to reject a filed rate before its use.

***Require the Department to generally define, in rule, factors that could result in a company being placed under prior approval.***

Quite distinct from attempting to protect consumers whose insurers are at great risk of insolvency, placing an insurer under prior approval for how that insurer calculates rates—what factors the insurer considers and does not consider, how those factors are weighted, etc.—is the type of subjective pre-market response identified by Sunset Commission staff.

Additionally, it is difficult to see how "a statewide insurance emergency" justifies placing a company (or companies)

under prior approval. Without a clear definition of what constitutes "a statewide insurance emergency," this section of the Code provides the commissioner a catch-all provision to justify placing any insurer(s) under prior approval. This vague statutory language does not provide the commissioner or insurers with clear guidance on the implementation of prior approval and has the potential to be the exception that swallows the rule (see TPPF Recommendation 3).

Instead of focusing on the possible reasons for placing an insurer under prior approval, a course of action more beneficial to the insurance market as a whole is to limit such assignment to only those insurers whose financial positions place them in imminent danger of insolvency.

***Require TDI to routinely evaluate the need for insurers to remain under prior approval, and require that insurers be notified in writing of the actions that need to be taken in order to return to file-and-use rate regulation.***

As with the two previous Sunset Commission staff recommendations, this starts with the correct diagnosis (partially implemented file-and-use system) but fails to reach the desired end of a true file-and-use system if companies can still be placed under prior approval for rating practices or a statewide insurance emergency. However, if implemented in conjunction with the Foundation's recommendations, this would be helpful in determining which companies no longer need to be under prior approval in cases where solvency is an issue. ✯

## About the Texas Public Policy Foundation

The Texas Public Policy Foundation is a 501(c)3 non-profit, non-partisan research institute guided by the core principles of individual liberty, personal responsibility, private property rights, free markets, and limited government.

The Foundation's mission is to lead the nation in public policy issues by using Texas as a model for reform. We seek to improve Texas by generating academically sound research and data on state issues, and recommending the findings to policymakers, opinion leaders, the media, and general public.

The work of the Foundation is primarily conducted by staff analysts under the auspices of issue-based policy centers. Their work is supplemented by academics from across Texas and the nation.

Funded by hundreds of individuals, foundations, and corporations, the Foundation does not accept government funds or contributions to influence the outcomes of its research.

The public is demanding a different direction for their government, and the Texas Public Policy Foundation is providing the ideas that enable policymakers to chart that new course.

900 Congress Ave., Suite 400 | Austin, Texas 78701 | (512) 472-2700 phone | (512) 472-2728 fax | www.TexasPolicy.com