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Property and Casualty Insurance

A state-by-state analysis of regulatory burden

By Eli Lehrer*

1. Introduction

According to *Barron's*, the U.S. dominates the world in providing property and casualty (P&C) insurance with 43.4 percent of worldwide P&C premiums. Japan is next with only 10.3 percent, and Germany third with 8.8 percent. Approximately 3,000 P&C insurance and reinsurance companies in the U.S. employ approximately 635,000 workers.[1]

Unfortunately, the way insurance is regulated in the U.S. distorts insurance products, raises their price, and limits their availability. Insurance regulation threatens to weaken or undermine one of the institutional pillars supporting free enterprise and economic prosperity.

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The Heartland Institute and Competitive Enterprise Institute embarked on this project in an effort to draw attention to the things that make some states good places for insurers and consumers and other states bad places for them. A focus on "good" and "bad" state laws, we hope, should serve to draw attention to the places most in need of attention and reform.

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[1] "Insurance," Allison McClintic Marion (ed.), *Encyclopedia of Business and Finance*. Gale Group, Inc., 2001. eNotes.com. 2006. 14 Feb, 2008 <http://www.enotes.com/business-finance-encyclopedia/insurance>

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This report card focuses on homeowners and automobile insurance, the two types of insurance Americans typically are required to purchase. State laws in 46 states mandate the purchase of automobile insurance, and nearly all mortgage lenders require that their clients secure homeowners coverage.

Most consumers (about 60 percent) buy their homeowners and automobile insurance policies from the same company. Nearly all companies that write homeowners insurance also write automobile insurance, and most auto insurers also write homeowners insurance. With a few exceptions—which our ratings consider—states regulate both types of insurance using the same (often identical) processes.

Our ranking focuses on two key questions:

1) How free are consumers to decide what insurance products will meet their needs?

2) How free are insurers to provide products that meet consumers' real or perceived needs?

2. Philosophy

We have written this survey with legislators and citizens in mind. Its findings may not always reflect the opinions of those in the insurance industry or "consumer rights" advocacy groups and, indeed, may sometimes run directly contrary to them.

We attempt to measure laws and outcomes, not bureaucratic processes. Some states with what appear to be "bad" laws may actually allow companies to approach the ideal of market pricing. Similarly, some states with good laws or competitive markets may create enormous bureaucratic nightmares.

This study focuses on *regulatory environments* rather than regulators. A grade of "F" is not an attack on a state's insurance department, nor is a grade of "A" an endorsement of the people running a state's insurance department. Rather both grades reflect the laws under which the states operate and point to opportunities for reform.

In addition, opportunities for reform exist in many states but are not highlighted by our methodology. If, for example, a state with a perfectly reasonable file-and-use law significantly under-staffs its insurance department, consumers with fraud complaints and companies wishing to file rates may quite understandably desire reform. But such reform would take the form of changes in people rather than law. A state that favors in-state (domestic) insurers over those operating elsewhere it may likewise create a seemingly "competitive" market without a very level playing field.

We believe insurance markets best accomplish their risk management function when they allow insurers to charge rates that reflect the actual risks their policy holders incur. When government regulation interferes with the price mechanism, it either suppresses rates overall or (more likely) redistributes the burden of paying for risk. This results in wealth redistribution from people who

behave safely to those who take greater risks. It is difficult to discern what political value systems would contend that this form of wealth redistribution advances worthy public policy goals.

We recognize that some insurance regulation—the enforcement of laws against force and fraud in the insurance business, for example—clearly belongs in the hands of the state. Other types of regulation—such as providing assurances that insurance companies can actually pay their claims—should involve a mix of private and state efforts. We believe some decisions—such as the price charged for insurance products—should remain very largely in the hands of market forces and voluntary arrangements.

While we proceed from this "free-market" starting point, we expect this ranking will prove useful to people with a wide variety of viewpoints. The states whose insurance departments have most fallen under the influence of self-styled consumer advocates—and rank the lowest in our survey—may provide the "best" insurance environment for those who disagree with our philosophy.

3. Methodology

We assess nine variables. In all but one case—where the nature of the data dictates a multi-year approach—we use data collected in 2006 and attempt, to the extent possible, to assess the situation as it was on December 31, 2006.

For each variable, the "modal" score—the score assigned to a plurality of states—is zero. It is important to note that a score of zero *does not* necessarily reflect a lack of regulations, only that a state is not very different from the rest of the country. When we scored actions, policies, and environmental characteristics as "pro-free market" we added points. Conversely, we subtracted points for anti-free market actions.

No research methodology is perfect, and ours is no exception. Any rating, to be objective, must apply the same criteria to each item being rated. Yet such a rating system can miss fundamental differences among the things being rated. We discuss some of these limitations below.

We are limited by the data we could find, create, or compile. For example, we were unable to collect systematic data about the condition of state guaranty funds, the professionalism of state insurance departments, or the quality of state programs to investigate force and fraud in the insurance industry. We would have liked to include such data but simply couldn't identify good sources.

We made no effort to evaluate policies or circumstances unique to a single state's insurance environment. South Carolina, for example, offers an innovative series of tax credits to encourage homeowners in hurricane zones to purchase private insurance. Nevada offers "named operator" insurance that applies to individuals independent of the cars they drive. Because both are *sui generis*, the ratings make no effort to reward (or penalize) the states for these policies, even though they may have significant consequences for the state's insurance environments. Because

no-file laws are the norm in the commercial lines insurance business, we do, however, score Illinois for its unique no-file for-personal-lines system.

The next several pages justify our choice of variables, explain how we calculated them, and identify the data we used to score them.

Residual Automobile and Homeowners Insurance Markets

Residual markets serve consumers for whom state government officials believe coverage in the private market cannot be found at a "reasonable" price. Two states (Florida and Louisiana) run full-fledged property insurance companies as state agencies, but most residual markets involve coalitions of private companies required by law to write insurance at rates determined through a politically imposed process.

Thirty-five states maintain residual property insurance markets. All states have residual automobile insurance market laws, although three do not write policies under these laws and seven wrote fewer than 10 policies in 2006. Although most states have laws that forbid the bailout of residual pools or make them independent of the government, no state government has ever allowed such a pool to fail.

Using data from the Automobile Insurance Plans Service Office and the Property Insurance Plans Service Office (two organizations that provide national services for residual property and automobile plans), we measured the size of residual markets for automobile and homeowners insurance.

Residual markets represent a state subsidy for people who take risks the free market is unwilling to absorb without higher premiums or some other form of compensation. The existence of residual insurance markets in a state is evidence of regulatory restrictions that prevent the free market from meeting the needs of consumers.

Most residual insurance markets are very small. It's unlikely, for example, that a few involuntarily written auto insurance policies representing less than half of 1 percent of the market would have serious consequences for automobile insurance prices in any state or affect consumers outside of it.

For each state where the residual market was either non-existent or represented less than half of 1 percent of the policies in the market, we scored 0. For states whose residual markets represented between .50 and .99 percent of the policies written, we scored -1. For states with residual more than 1 percent of the market, we subtracted points equal to the percentage in the residual market plus 1. (In other words, a state with 2 percent of policies written in the residual market would receive a score of -3.)

Market Volatility

Market volatility was measured by calculating the standard deviation of the insurance company

loss ratios for private passenger auto policies for five years; the higher the deviation from the mean, the greater the volatility. Significant volatility of homeowners insurance loss ratios typically reflects natural disasters—insurance companies lose money when disasters strike—and may have nothing to do with the regulatory climate. Thus, we did not score it.

Highly volatile loss ratios in the auto insurance market often reflect an uncertain regulatory climate that makes it difficult for insurers to operate and consumers to receive consistent, predictable, risk-based prices. For this reason, we scored only automobile insurance on this measure.

Note this measure does not reflect overall profitability. A "good" insurance environment may or may not produce short-term profits for insurance companies, whereas a "bad" one may have produced significant profits over a five-year period.

The five states with the highest deviation (that is, the most volatility) received a score of -5 and the next five highest received a score of -3. The 31 middle-scoring states received a 0 score. The five states with the smallest deviation received a score of 5, and the next five states with the smallest deviation received a score of 3.

Market Concentration

A well-functioning market of any type will tend to contain a variety of competitors whose products fill different and competitive niches. Such competition tends to benefit consumers. While market concentration per se is not a sign that consumers are being ill-served, it can be a sign of regulatory barriers to entry and market dysfunction. Therefore, we reward states with competitive insurance markets and take points away from states with highly concentrated markets.

We calculated concentration using 2005 market data collected by AM Best. Using a modified Herfindahl-Hirschman Index (HHI), the widely accepted standard for measuring market concentration, we analyzed the market percentage share of the 10 companies with the highest market shares.[2] After squaring the market share of each of the top 10 companies for total private passenger auto, we added the results to calculate the HHI. We used the same method to calculate the HHI for homeowners market concentration.

In each category, we gave the five most-concentrated states a score of -5 and the five next most-concentrated a -3. The middle 31 received a score of 0. The five least-concentrated states received a score of 5, and the five next least-concentrated states received a score of 3.

We scored homeowners and automobile markets separately because different types of

[2] HHI is calculated by looking at every firm in a given market, so our results only approximate HHI. In nearly all states, the 10th-ranked firm had a market share of less than 2 percent, thus including additional firms would have had only a very minor effect on market share. Ranking the top 15 companies—which we experimented with—would not have changed any state's letter grade. Thus, for all intents and purposes, our methodology is equivalent to computing HHI through the formally correct process.

regulations may impact the two markets. Overall market concentration is scored out of a possible -10 to +10 points.

Form Regulation

All states regulate the forms insurance companies present to their policyholders for claims, policy descriptions, and the like. Insurance companies operating in a competitive market are better-positioned than state bureaucrats to design forms that gather the information they need—no more and no less—and are easy for consumers to understand and use. Therefore, we award points to states that have minimal form regulation and deduct points from states with heavy regulations.

Some states require insurance companies to use state-developed forms. In other states, companies are permitted to develop their own forms but must submit them to regulators for approval before use ("prior-approval" regulation). Still other states have "file-and-use" laws, where companies develop their own forms, must file them with regulators, and may begin using them immediately—approval by regulators is assumed, although the forms may be challenged by regulators at any time. States with any of these types of form regulation received a score of 0.

States with "use-and-file" laws—where companies develop their own forms and must file them with regulators for information purposes, but where regulators have relatively little authority to challenge the forms used—received a score of 5.

Although important in many cases, form regulation does not have the same impact as other types of regulation, and thus we weight it less. In cases where form language has had a significant statewide impact on insurance rates and availability—as in a series of cases involving mold in the state of Texas—the consequences have come from judicial systems rather than insurance law itself.

Rate Regulation

Forty-nine states exert some degree of direct control over the rates insurance companies charge. When regulators establish rates themselves or require specific justification for the rates insurance companies establish, factors other than risk become more important to the rate-setting process than they ought to be. Regulators typically set lower rates for politically favored groups and higher rates for disfavored groups. For example, in Florida a massive state-run insurance company—the largest homeowners insurer in the state—guarantees lower-than-market rates for people who live in coastal areas and, as a result, will tend to raise private homeowners insurance rates in inland areas.

Many states employ file-and-use rate regulation. Companies are required to develop rates and file them with regulators, along with justifications explaining why the rates were set as they were. Upon acceptance of the paperwork by the regulators, the rates can be used by the insurance companies.

Other states use flex-rating systems, which are often paired with file-and-use systems. Flex-rating allows companies to charge rates within a certain range without any specific rate-filing. States with "file-and-use" and "flex-rating" systems received a score of 0. Some states with file-and-use laws on the books have, from time to time, given notice to insurance companies that they would not approve rate filings, thus turning their systems into *de facto* prior-approval systems. We would have liked to survey the exact way states with file-and-use laws administer them and will do so in the future. Obtaining objective data as to the administration of file-and-use, however, proved impossible.

Other states require regulators to pre-approve all rates. Such "prior-approval" regulation tends to lower rates for groups that take large risks, and raise rates for those who avoid risks. Although prior approval generally tends to reduce the number of changes in rates, it also tends to result in more extreme swings in rates. Because it tends to make the approval process much more difficult, insurers tend to request much larger increases (and rate cuts) when they change the rates being charged. States with prior-approval laws received a score of -10.

Other states require filings that are largely informational in nature. These "use-and-file" states grant insurers a great degree of freedom in setting rates but still require insurers to inform state authorities of the rates. In many cases, state authorities retain the ability to roll back or otherwise disapprove rates they believe excessive. These states were scored 10.

One state, Illinois, allows insurer and consumer interactions to set rates. Insurance companies must maintain certain files and open them to inspection by the state. Insurance companies are required only to charge actuarially adequate rates (a *de facto* price floor) and may not charge unconscionable rates (a *de facto* ceiling). This system allows much greater freedom than any other, and thus Illinois received a score of 20.

Three states—Florida, Massachusetts, and North Carolina—establish rates through the political process. Florida operates a state agency, the Citizens Property Insurance Corporation (Citizens), that will sell insurance to anybody who receives a single insurance quote more than 15 percent above Citzens' rates. Massachusetts directly dictates the rates automobile insurers charge (although it will stop doing so in 2008), while North Carolina has imposed a *de facto* price cap that makes it impossible for insurers to write actuarially sound policies for about one-quarter of the state's residents. In all these cases, state regulators—rather than market forces—directly determine rates. These states received a score of -20.

Credit Scoring

Because credit scores are widely available and reasonably reliable for determining risk factors, insurance companies consider them valuable for setting rates.

Seven states significantly restrict insurance companies' use of credit-scoring information for setting rates in ways that amount to all-out bans. States that ban its use entirely, or impose restrictions so severe it becomes useless, received a score of -10. States that significantly limit the use of credit scoring without an all-out ban, or limit the use of credit scoring in one category of insurance but not another, received a score of -5.

We did not score restrictions on the use of credit scoring in fields other than automobile insurance and homeowners insurance, and we also ignored state laws that bar the use of credit scores as a "sole" factor in determining insurance rates. No company uses such scores as a "sole" factor, so this legal restriction has no real meaning.

As with all other variables, most states received a score of 0.

Territorial Rating

The location of insured property, be it a residence or an automobile, can have a great effect on insurance rates. People who build houses on sand dunes should expect to pay higher homeowners insurance rates than those who live well inland, and those who live in neighborhoods plagued by auto theft and vandalism should expect to pay higher automobile insurance rates than those in more secure neighborhoods.

Some states ban territorial rating outright. These states received a score of -10.

An additional group of states places partial restrictions on territorial rating: They may ban it for automobile insurance but allow it for homeowners insurance, for example, or they may mandate that rates be the same within the borders of a given city or county. These states received a score of -5. Other states limit the amount of territorial rating companies can do or the percentage of rates that may be determined by location. These states also received a -5.

Most states disallow the use of territorial rating as a "sole" factor in determining rates or place other similarly broad limitations on the degree to which it may be used in determining rates. All states with such laws received a score of 0. But we note the laws are enforced to varying degrees, and further research on this point is needed to more accurately determine how onerous the laws are in practice.

Finally, some states have no territorial rating restrictions at all. These states received a score of 10.

4. Results

We graded on a curve using a modified standard deviation.

We calculated a total score for each state and a mean, then calculated a modified standard deviation after dropping three outliers: Florida, Massachusetts, and North Carolina. In all three states, insurance rates are determined entirely through the political process. We penalized those states heavily, and doing so distorted the standard deviation upward a great deal. Removing those three states from the standard deviation calculation resulted in a more normal curve.

States more than one modified standard deviation above the mean were given the grade of A. States above the mean within one standard deviation received a B. States within one standard

deviation below the mean received a C. States between one and two standard deviations below were given a D, and states more than two standard deviations below the mean were given an F.

Because of the limitations inherent in this study, we urge readers to focus on the letter grades rather than the raw scores we calculated. Although we're reasonably confident most states with the same letter grade will create a similar experience for consumers, insurers, and agents, we're far less confident that relative scores *within* letter grades make a major difference. Because reasonably few states ended up in the C range, the states receiving that grade represent a particularly diverse bunch.

Five states were given the top grade of A: Vermont, Idaho, Utah, Illinois, and Wisconsin. We believe these states provide the best regulatory environment for insurance consumers and providers. Their raw scores ranged from to +13 for Wisconsin to +27 for Vermont.

Five states earned the lowest grade of F: California, Maryland, Florida, North Carolina, and Massachusetts. Their regulatory climates are hostile to insurers as well as consumers. Their raw scores ranged from -27 for California to -67 for Massachusetts.

Given that we designed the study to make 0 the modal score for all variables, it is not surprising that nine states (Nevada, Arkansas, Kansas, Minnesota, Oklahoma, Oregon, Montana, Alaska, and Tennessee) received overall scores of 0 and ratings of "B." This doesn't mean nothing is exceptional about any of these states: Nevada, as noted above, has a unique "named operator" system for registering cars. In many cases, variables cancel one another out. For example, Alaska—not surprisingly, given its small population and geographic remoteness—has highly concentrated markets in all categories. On the other hand, its consumers benefit from a lack of territorial rating restrictions.

Parts 5-9 of this report present case studies of five states. More brief discussions of eight states appear below.

Vermont

Vermont received the highest raw score. Although not typically known for its free-market policies, the state has become a hotbed of insurance innovation. The state created the nation's first Captive Insurance law and, despite a small population, is home to more than 500 insurance companies. Consumers in Vermont enjoy one of the nation's most competitive insurance markets, and companies operating in the state set rates under a free-flowing use-and-file system. Although the state maintains a minuscule residual automobile market, this does not detract from a very good overall insurance environment.

Illinois

Illinois has a unique-in-the nation no-file system for personal rates. Because it is home to the nation's two biggest insurers—State Farm and Allstate— the state has one of the nation's more concentrated automobile and homeowners insurance markets. The state has shown notable

progress in doing away with a residual homeowners insurance market that was once the state's largest writer of homeowners insurance but now writes fewer than 1,000 policies throughout the state.

Connecticut

Connecticut scored a B on our ratings largely because it has created a highly competitive market for insurance. Consumers have a plethora of choices in all fields—the markets are among the nation's least concentrated—and insurers have enjoyed remarkably stable loss ratios. The state, however, has some limitations on the use of territorial rating, and consumers and insurers complain about slow turnaround times in some parts of Connecticut's insurance department.

New Jersey

Although hardly a paragon of free-market insurance regulation, New Jersey—which gets a "B" in these ratings—has come a long way from its recent status as home of the nation's largest residual auto market as measured by number of policies. Although the state maintains residual markets for both automobile and homeowners insurance (taking up 7 and 2 percent of policies respectively), it has recently gone to a straightforward file-and-use system for setting rates, has seen automobile insurance premiums decline, and promises to shrink its residual automobile insurance market. The state also maintains highly competitive markets and has shown stable loss ratios, indicating a stable profit-loss environment. Like Connecticut, it limits territorial rating without an all-out ban.

Washington, D.C.

By most accounts, the District of Columbia's insurance market serves consumers and insurers rather well. Like Vermont, it welcomes captive insurance companies and administers rates under a permissive file-and-use system. Under our rating, however, it receives a downgrade—to a "C"—entirely because it has a highly concentrated market. Given that this market consists of a single high-density city of about 550,000 residents, a concentrated market could emerge for competitive reasons and not harm consumers. Indeed, it is rather remarkable that Washington, D.C.'s homeowners insurance market *isn't* among the country's five most concentrated.

Michigan

Michigan—which suffers from high unemployment rates and high taxes—also received a C. Unlike the District of Columbia, however, which probably does not need to make any significant changes to its regulatory environment, Michigan needs to deregulate. Measured by both percentage of the market and number of policies written, the state has the largest residual homeowners insurance market of any state outside of a hurricane or earthquake zone. Regulatory uncertainty (shown through high loss ratio volatility), pre-approval of all forms, and significant prohibitions on the use of territorial rating also depress Michigan's score. Given the state's weak

economy and tendency towards over-regulation, things may get worse before they get better.

Florida

Florida also comes in near the very bottom of our ratings, almost entirely because of its unusually intrusive homeowners insurance system. Since Massachusetts announced it would stop dictating the rates that insurance companies charge beginning this year, Florida has emerged as the only state that directly dictates insurance rates through state action (although North Carolina's system is only slightly less direct). Florida also has entered the insurance business on its own through a state agency, the Florida Citizens Property Insurance Corporation. To a large extent, Florida's regulatory over-stretch remains limited to its homeowners insurance market. The state's auto market—free from state-mandated rates—ranks among the 10 most competitive in the country.

Massachusetts

Massachusetts receives the worst raw score in our rankings. Although its score will improve thanks to the end of state-created rates for automobile insurers, the state still has much work to do. It remains the only state that has sizeable residual markets in both automobile and homeowners insurance. It has subjected insurers to enormous loss ratio volatility (reflecting regulatory uncertainty) and bars all use of territorial rating. Although the state has a highly competitive homeowners insurance market, the competition results largely from government interference and companies' lack of desire for a large market share, rather than genuine consumer choice.

5. Scores

The table below presents the scores for all 50 states and the District of Columbia on each of the nine variables and the resulting letter score.

State-by-State Analysis
(in alpha order by state)

State	Letter Grade	Score	Residual Auto	Residual Homeowners	Market Concentration Auto	Market Concentration Home	Loss Ratio Stability	Rate Regulation	Form Regulation	Credit Scores	Territorial Restrictions
Alabama	B	-3	0	0	-3	-5	5	-10	0	0	10
Alaska	B	0	0	0	-5	-5	0	0	0	0	10
Arizona	B	10	0	0	5	-5	0	10	0	0	0
Arkansas	B	0	0	0	0	0	0	0	0	0	0
California	F	-27	0	-2	5	0	0	-10	0	-10	-10
Colorado	B	-3	0	0	0	0	-3	0	5	0	-5
Connecticut	B	10	0	0	5	5	5	0	0	0	-5
Delaware	C	-8	0	0	-3	0	0	0	0	-5	0
District of Columbia	C	-8	0	0	-5	-3	0	0	0	0	0
Florida	F	-41	0	-19	0	3	0	-20	0	0	-5
Georgia	C	-4	0	-1	0	-3	5	-5	0	0	0
Hawaii	D	-20	0	0	0	0	0	-10	5	-10	-5
Idaho	A	23	0	0	3	0	0	10	0	0	10
Illinois	A	14	0	0	-3	-3	0	20	0	0	0
Indiana	B	5	0	0	0	0	3	0	5	0	0
Iowa	B	10	0	0	0	0	0	10	0	0	0
Kansas	B	0	0	0	0	0	0	0	0	0	0
Kentucky	B	8	0	-2	0	0	0	10	0	0	0
Louisiana	D	-20	0	0	-5	-5	-5	-5	0	0	0
Maine	B	10	0	0	5	5	0	0	0	0	0
Maryland	F	-29	-9	0	0	0	0	0	0	-10	-10
Massachusetts	F	-67	-12	-10	-5	5	-5	-20	0	-10	-10
Michigan	C	-11	0	-3	0	0	-3	0	5	0	-10
Minnesota	B	0	0	0	0	0	0	0	0	0	0
Mississippi	C	-5	0	-2	-3	-5	-5	0	0	0	10
Missouri	B	0	0	0	0	0	0	10	0	0	-10
Montana	B	0	0	0	0	0	0	0	0	0	0
Nebraska	B	-3	0	0	0	0	-3	0	0	0	0
Nevada	B	0	0	0	0	0	5	-5	0	0	0
New Hampshire	B	8	0	0	3	5	0	0	0	0	0
New Jersey	B	-3	-7	-2	3	3	5	0	0	0	-5
New Mexico	B	8	0	-2	0	-3	3	0	0	0	10
New York	D	-22	-7	-2	0	0	-3	-5	0	0	-5
North Carolina	F	-45	-28	0	0	0	3	-20	0	0	0
North Dakota	C	-5	0	0	0	0	0	-5	0	0	0
Ohio	B	1	0	-2	0	3	0	0	0	0	0
Oklahoma	B	0	0	0	0	0	0	0	0	0	0

Oregon	B	0	0	0	0	0	0	0	0	0	0
Pennsylvania	D	-20	0	0	0	0	0	-10	0	0	-10
Rhode Island	B	3	0	-7	3	5	-3	0	5	0	0
South Carolina	B	-3	0	0	-3	0	0	0	0	0	0
South Dakota	B	3	0	0	0	3	0	0	0	0	0
Tennessee	B	0	0	0	0	0	0	-10	0	0	10
Texas	D	-15	0	-2	0	-3	0	0	0	0	-10
Utah	A	15	0	0	0	0	-5	10	0	0	10
Vermont	A	27	-1	0	5	3	0	10	0	0	10
Virginia	B	-3	-1	-2	0	0	0	0	0	0	0
Washington	B	6	0	0	3	0	3	0	0	-10	10
West Virginia	C	-5	0	0	-5	0	0	0	0	0	0
Wisconsin	A	13	0	0	0	0	3	10	0	0	0
Wyoming	B	-3	0	0	0	0	-3	0	0	0	0
Mean		**-3.901961**									
Modified STDEV		17.08									

6. Case Study: Florida

By Eli Lehrer

Although Florida possesses a highly competitive automobile insurance market, a series of government efforts over the past 15 years has crippled the ability of the state's private insurers to provide effective homeowners insurance. Already burdened with a heavily concentrated homeowners insurance market and some of the nation's highest homeowners insurance rates, Florida consumers saw the state assume massive new liabilities. The situation resulted in large-scale retreat of private insurers and a declining state bond rating, with the very real prospect of higher taxes for all Floridians. For most Floridians, premiums continued to rise.

Hurricane Andrew

The path that leads to Florida's current insurance system begins with the aftermath of Hurricane Andrew in 1992. In the wake of the storm and several brushes with insurer insolvency, the Florida legislature convened three separate special sessions in 1992 and 1993.[3] Those sessions resulted in the creation of the Joint Underwriting Association and the Hurricane Catastrophe Fund and an expansion of the Florida Windstorm Underwriting Association.

The three entities were intended to provide hurricane-related insurance to people unable to find it in the private market.

The Joint Underwriting Association theoretically served as a short-term market "safety valve," while the Windstorm Underwriting Association provided ongoing coverage to Floridians who couldn't get coverage elsewhere. The so-called "Cat Fund" made it easier for private companies to offer reasonable insurance rates by selling them discounted re-insurance.[4] These three mechanisms—the first two now merged into the Florida Citizens Property Insurance Corporation—still comprise the essentials of government intervention in Florida's system for providing property insurance.

Homeowners Demand Rises

As hurricanes continued to batter the state in the early '00s—leading to a greater demand for products from the Joint Underwriting Association and Windstorm Underwriting Association—the legislature, in 2002, combined the two to create the Citizens Property Insurance Corporation. Although it continued to write some wind-only coverage, Citizens was,

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[3] Jan Gorrie, "Property Insurance in Florida: The 1997 Legislative Reform Package," *Florida State University Law Review* 25: 351, 352.

[4] Ibid 352-354.

by design, a full-line homeowners insurer that replaced all homeowners coverage in certain cases and contracted out little business.[5] Still, homeowners insurance rates continued to rise throughout the state.

The Catastrophe Fund grew in 2004 when Gov. Jeb Bush signed the first of several capacity expansion bills, raising its limit to $15 billion.[6] Following a particularly vicious 2004 hurricane season the legislature debated and ultimately passed a bill that combined some modest insurance reforms with a major relief effort for those without insurance.[7]

As homeowners faced continual battering from hurricanes and rising premiums, Gov. Bush requested more reforms to the system and, in 2005, he got them. Senate Bill 1486 shrunk the Cat Fund, created a hurricane loss mitigation program, required insurers to offer higher deductibles to consumers who wanted them, mandated discounts for mitigation, and, perhaps most importantly, allowed Citizens to compete freely with the private market in Monroe County (the Florida Keys.)

This package of reforms would stand, more or less intact, until early 2007. But rates continued to soar, doubling in 2006 alone for many in South Florida.

Sweeping Reforms in 2007

Those quickly rising rates, coupled with record insurance company profits, led to populist outrage. On the campaign trail, gubernatorial candidate Charlie Crist called for insurance reforms, and upon taking office he almost immediately called a special session of the legislature to consider them. Thanks to strong-arm tactics—the only two legislators to vote against the reform proposal found themselves removed from key chairmanships—the outcome was never really in doubt.

Bill 1A, the Insurance Industry Accountability and Consumer Protection Act, significantly changed the system by which Floridians purchase insurance. Its provisions include:

- A rollback of January 2007 rate increases for Citizens Property Insurance Corporation and a prohibition on rate increases by Citizens until 2009.

- A major change in the laws covering Citizens. Once only a "carrier of last resort" that required an applicant to provide evidence of being rejected several times before it would

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[5] Florida Citizens Property Insurance Corporation. "Company Overview," http://www.citizensfla.com/about/generalinfo.cfm.

[6] HB 2488.

[7] David Royse. "Florida Legislature Passes Hurricane Bill," The Associated Press, December 16, 2004.

write a policy, Citizens must now write policies to anybody who receives one insurance quote more than 15 percent above its rates.

- An elimination of the requirement that Citizens have sufficient reserves to survive a "one hundred year" hurricane.

- An anti-cherry-picking provision that requires all insurers selling auto insurance in the state to write homeowners insurance as well if they offer it anywhere in the country.

- Taxes on "excess profits."

- A *de facto* repeal of the mandate that Citizens buy private re-insurance. (Citizens did not purchase any such re-insurance in 2007.)

- A massive expansion of the Hurricane Catastrophe Fund.

Bill 2498, simply "An Act Relating to Insurance," which passed later in 2007, continued in the same vein with a number of tweaks to the fundamental system. Among other things it contained provisions to:

- Expand the Cat Fund and allow very small insurance companies to buy into it.

- Allow consumers to receive coverage from Citizens immediately after having their applications accepted.

- Make it easier for those who leave Citizens for other companies to go back to Citizens.

- Require insurers to pay or deny a claim within 90 days of receiving it.

- Make it more difficult for insurers to exclude contents coverage when writing homeowners insurance policies.

Citizens Property Insurance Corporation

Since 2002, Citizens has existed, in theory, to write insurance for Floridians living "in high-risk areas and others who cannot find coverage in the open, private insurance market."[8] Although it maintains a private-sector façade, Citizens is, in fact, an unusually powerful government agency.

Citizens enjoys an exemption from most state purchasing and hiring rules and a corporate-style

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[8] Florida Citizens Property Insurance Corporation. "Company Overview," http://www.citizensfla.com/about/generalinfo.cfm.

structure that puts a CEO at its head. Its Web site, at a glance, looks like that of a mid-sized private insurer, and it pays salaries comparable to those available in the private sector.[9] It has many of the freedoms typically accorded to private businesses. Florida's own statutes, however, make it clear that Citizens is a government agency in every way.

> Because it is essential for this government entity to have the maximum financial resources to pay claims following a catastrophic hurricane, it is the intent of the Legislature that Citizens Property Insurance Corporation continue to be an integral part of the state and that the income of the corporation be exempt from federal income taxation and that interest on the debt obligations issued by the corporation be exempt from federal income taxation.[10]

Citizens has been given the authority to impose taxes on every insurance policy issued anywhere in the state of Florida. When it sustains a substantial loss—more than 10 percent—it has the unilateral power to impose taxes (called "assessments") sufficient that "the entire deficit shall be recovered through regular assessments of ... insurers [and] insureds."[11] State law places no limits on these taxes and applies them to everybody in the state, including people who have never done business with Citizens.

Despite its corporate front, Citizens may well be the single most powerful instrumentality of Florida state government. If the Department of Highway Safety and Motor Vehicles, for example, wants to expand the hours of its driver's licensing offices, it must ask the governor and legislature to add money to its budget. To get the money, the state must either raise it through taxes or borrow it. Florida Citizens, by contrast, has the power to impose taxes on its own authority.

Not surprisingly, given the low premiums it charges homeowners, Citizens has grown very large. As of the end of August 2007, it had issued more than 1.36 million policies representing more than one-third of Florida's homeowners insurance market.[12] It does the most business in Broward, Palm Beach, Dade, and Monroe Counties. Together, these four counties represent about one-third of the state's population, but they account for two-thirds of Citizens' business.

Since Citizens specializes in writing policies in high-wind areas, the quiet hurricane seasons of 2006 and early 2007 allowed it to build up a surplus of nearly $2 billion as of early August 2007. Although barred by statute from operating for the benefit of "any private person," Citizens faces few hard-and-fast restrictions on how it spends or invests this surplus. Crist, the *St. Petersburg*

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[9] See, for example, Florida Citizens Property Insurance Corporation. "Our Vision," http://www.citizensfla.com/about/generalinfo.cfm?show=pdf&link=/shared/generalinfo/pdf/missionvalues.pdf.

[10] 627 Florida Statutes .351(6)(1).

[11] 627 Florida Statutes .351(6)(2)(3)(a).

[12] Florida Citizens Property Insurance Corporation, *Combined Summary Report: August 31, 2007.*

Times reports, predicted a 24 percent decline in insurance rates.[13] For reasons we discuss below, that has not yet happened.

The Catastrophe Fund

While Citizens maintains a high public profile as the state's largest homeowners insurer, an agency with a much lower profile plays an even greater role in Florida's insurance system. The State of Florida Hurricane Catastrophe Fund, created in 1993, exists to "protect and advance the state's interest in maintaining insurance capacity in Florida by providing reimbursements to insurers for a portion of their catastrophic hurricane losses."[14] The Catastrophe Fund serves as the largest re-insurer in Florida. Like Citizens, it is a government agency. But, despite its vast reach, it exists as an obscure bureau buried deep within the State Board of Administration.[15]

Until the 2007 special session, the Cat Fund remained a reasonably minor entity that re-insured smaller companies and the then-small Citizens. (Larger companies could almost always get re-insurance for less in the private market.) Today, the Cat Fund has become the largest and most important re-insurer in Florida. Since it underwrites the great bulk of Citizens' risk, its existence provides a prop for Citizens. By providing re-insurance at below-market rates, the Cat Fund theoretically allows insurance companies, including Citizens, to write insurance policies at lower rates.

In fact, it appears the Cat Fund may actually increase costs. Current Florida law requires all insurers doing business in the state to purchase re-insurance through the fund. This re-insurance costs less than similar coverage in the private market and, in theory, would allow insurers to cut rates. Unlike traditional re-insurers, however, the Cat Fund does not carry out a serious investment strategy or attempt to grow its business. Instead, like Citizens, it has the authority to impose new taxes (in the form of assessments) to pay off whatever bonds it might issue. Earlier this year, the fund issued more than $5 billion in debt to build up its cash reserves—the state's largest-ever single debt issue.

The $5 billion in new bonds—which alone increase the state's debt almost 20 percent—pales in comparison to how much the Cat Fund *could* cost the state. Under current law, the fund has the

[13] Tom Zucco, "24% rate drop just a dream; insurance nightmare is back," *St. Petersburg Times*, March 18, 2007.

[14] Florida Hurricane Catastrophe Fund. "About FHCF," http://www.sbafla.com/fhcf/about.asp.

[15] The chief authorizing statute is S. 215.555.

authority to issue $28.42 billion in bonds.[16] No U.S. state or city has ever issued nearly that much debt.[17]

Standard and Poors' assessment of the situation was typical. Although noting the fund has strong political support, it also warned, "the potential for significant additional debt has increased for the next three years, and future changes in liability and bonding capacity will continue to be an important part of our credit analysis."[18]

Even the state Board of Administration, which oversees the Cat Fund and would issue most of the bonds, wouldn't promise that it can find buyers for the debt. In response to written questions the author submitted, the board dismissed the question as "speculative" and offered a dodge when I asked them about it: "There's no way to account for all contingencies and twists the economy might take that could impact large debt financing," board officials wrote. "What is more important is for insurers to study [the Cat Fund] and develop their own confidence based on the information that we provide for them."[19]

Rate Regulation

Although 49 states regulate insurance rates in some way, the 2007 insurance reforms made Florida's rate regulations particularly burdensome.

Florida not only requires that state bureaucrats sign off on all rates—something about half of all states require—but it also mandates that the insurance commissioner and insurance companies attend public hearings on just about every major request for a modification in rates.

Not only do insurance companies have to go through the burden of hearings, but the state has eliminated appeals panels that quickly decided cases when a dispute existed. Today, insurance companies who dislike the state's decisions have little choice but to launch expensive court proceedings.

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[16] Raymond James, "Estimated Claims Paying Capability," Florida Hurricane Catastrophe Fund, May 2007. http://www.sbafla.com/fhcf/pdf/ac-meetings/2007/Bonding%20Capacity%20Estimates-May%202007.pdf.

[17] The largest single bond issue to date was California's $11 billion 2002 bond issue to pay for the costs of resolving its energy crisis. See http://www.insurancejournal.com/news/southeast/2007/08/27/83021.htm. Although it involved bond issues from multiple agencies, Massachusetts spent even more—about $15 billion—to finance its "big dig" to build an underground expressway through downtown Boston.

[18] Robin Prunty and John Sugden-Castillo, "Florida Hurricane Catastrophe Fund Corp. Florida Hurricane Catastrophe Fund," Standard and Poors Ratings Direct, January 25, 2007.

[19] Correspondence in author's files.

The Future

Although they have failed to deliver the lower private-market rates that many Floridians expected and Crist promised, the 2007 insurance reforms appear to be reasonably popular. Citizens has continued to grow and saw its market share near 40 percent by the end of 2007.

If Florida remains storm-free, the state could either reform the system painlessly, by selling Citizens to a private company and removing its power to tax, or build up a large-enough reserve for Citizens to pay any claims that might come along.

By all accounts, however, that rosy outlook appears unlikely. Florida has more miles of coastline than any other state; it continues to build significant numbers of structures along its coast; and it will almost certainly continue to experience hurricanes. Florida's taxpayers remain on the hook for enormous liabilities.

Making the situation better will require significant, ongoing changes to Florida's system for dealing with hurricanes. Three realistic reform alternatives exist: tweaks to the existing system, establishment of a stable state-run wind insurance mechanism, and a phase-out of Citizens.

- *Tweaking the existing system.* The state might, for example, impose broad-based taxes to prop-up Citizens—a one penny sales tax for this purpose appears to have some support—create ongoing premium taxes, or sell off parts of Citizens' portfolio to private companies while maintaining a state guarantee. Such measures, however, would preserve most of the status quo with all of its problems. Although some such tweaks might help (or hurt) Citizens at the margins, the state would retain its massive liability exposure.

- *Creating a stable wind re-insurance system.* By virtue of its size, a true single-payer wind re-insurance system would likely have a better chance of surviving a storm than Citizens has. If it were to capture all of the wind insurance premium in the state under one umbrella, even a few years' surplus could help the state survive all but the biggest storms. Former state Rep. Don Crane and a group surrounding him have forwarded this idea. While attractive in some respects—it would likely move the state closer to risk-based premiums—the idea appears to have some serious flaws. Essentially, it would remove market forces from the provision of wind insurance altogether and leave it entirely in the hands of the state. Private insurance companies would remain as claims servicers with little real role in managing risk. While fiscally more stable, the plan essentially does away with the possibility that insurance can play a creative role in managing risk.

- *Phasing out Citizen's.* State Rep. Dennis Ross, one of the two legislators to vote against Crist's 2007 plan, has proposed doing just that. Most importantly, Ross proposes to make Citizens partly self-assessing: requiring the agency to tax its own policyholders (he has proposed 25 percent of premium) before taxing the rest of the state. Thus, Citizens would retain its ability to offer lower rates than the private market but, at the same time, its policyholders would bear a substantial share of the risk for their subsidized coverage. Over

time, such a plan might lead to a partial or even complete phase-out of Citizens. It would, however, result in higher premiums for many Floridians.

In short, there's no quick or easy solution to Florida's insurance problems. Ultimately, Citizens will require significant reform and Florida will need to move towards a freer market for homeowners insurance throughout the state.

7. Case Study: Illinois

By Matthew Glans

Since 1970, companies offering homeowners and automobile insurance in Illinois have not been required to file rates with state regulators.

Although insurers must keep records to justify their rates, make sure they adhere to standards of actuarial adequacy, make informational filings of homeowners insurance rates, and follow common law standards of conscionability, state law provides distinctly limited political control over insurance rates.

This 37-year experiment with the free market appears to have worked well for Illinois consumers and insurers alike. But, perhaps because of the accidental nature of the system's evolution, no other state has replicated it.

This essay describes the evolution of Illinois' insurance system, outlines its consequences for the state, puts forward a theory as to why the system has not spread beyond Illinois, and suggests a strategy for replicating it elsewhere.

Regulatory Beginnings

Little in Illinois' history suggests the state would have established such an unusual insurance regulatory process. Following Congress's 1945 McCarran-Ferguson Act, which forswore federal insurance regulation but mandated state regulation, Illinois imposed a typical-for-its-era prior-approval insurance law in 1947.[20] Under the law, insurers had to file rates with state authorities, who examined the rates and either approved or disapproved them.[21]

[20] 15 USC 20.

[21] Lawyers Cooperative Publishing Company, *American Law Reports Annotated*, Vol. 91, p. 809.

Illinois and other states began realizing the burdens of this system in the 1960s. Illinois passed an "open competition" law in 1970. Like many insurance laws of its era, the system retained a strong degree of state oversight without the burdens of prior approval: Insurers were required to file rates before using them ("file-and-use") and could adjust them within narrow bands without state approval ("flex-rating").

Because of gridlock in the legislature, however, the law passed with a "sunset provision" for August 1971. When the law expired and the General Assembly could not agree on a replacement law, Illinois simply had no rating law at all. Thus, through legislative happenstance, Illinois became the only state in the country without a law regulating insurance rates.[22]

Other Laws Have an Influence

Although free of rate regulation, the insurance market in Illinois is influenced by other state laws. For example, the Illinois State Guarantee fund, which in-state insurers are required to join, requires a certain amount of regulation.[23] Insurers in the state's residual market for automobile insurance, and its tiny FAIR plan homeowners insurance system, are governed by a prior-approval rate-regulation system.[24]

Nonetheless, the state's automobile and homeowners insurance markets operate in a regulatory environment significantly less restrictive than other states in the country. The system appears to have worked: It provides consumers with a reasonably broad choice of insurers; predictable, risk-based rates; and premiums well in-line with the national average.

Stephen D'Arcy's sweeping study of the Illinois' insurance environment concludes the system has not resulted in excessive rates.[25] The Insurance Information Institute has found Illinois consumers pay slightly below-average insurance rates.[26] Annual premiums are about average or slightly below average among all states for average auto and homeowners insurance premiums.[27]

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[22] Stephen D'Arcy, "Insurance Price Deregulation: The Illinois Experience," in J. David Cummins (ed.), *Deregulating Property-Liability Insurance: Restoring Competition and Increasing Market Efficiency*, AEI-Brookings Joint Center, 2001, 257.

[23] Illinois Insurance Guarantee Fund. "Facts and Policies," http://www.idfpr.com/doi/General/guarantyfunds_facts.asp.

[24] See Illinois FAIR Plan Association, "Who We Are," http://www.illinoisfairplan.com/about_whoweare.asp; Illinois Automobile Insurance Plan, "General Information," http://www.aipso.com/il/geninfo.asp.

[25] Stephen D'Arcy, supra.

[26] Insurance Information Institute, "Average Expenditures for [Automobile] Insurance by State, 2004-2005," http://www.iii.org/mdia/facts/statsbyissue/auto/.

[27] Ibid.

After adjusting for factors like traffic density and urban population, automobile insurance rates in Illinois are lower than those in comparable states with prior-approval systems, and similar to those in states with less-restrictive ratings schemes.[28] Consumers are also protected from rate shocks: D'Arcy finds Illinois has smaller but more frequent price changes than states that regulate heavily.[29]

The level of competition also appears robust, at least in some respects. While a few larger companies have significant shares of the state's automobile insurance market, at least at one time, Illinois had more companies writing automobile insurance than any other state.[30]

Although it's difficult to separate cause and effect in this case, it's worth noting the state has become a major insurance hub. The nation's two largest property and casualty insurers—State Farm and Allstate—have their main corporate headquarters in Illinois, as do several other significant insurance companies, including CNA and American Family Insurance. One major re-insurer, Aon, moved to the state since the state's regulatory law expired, and two major life insurers (Prudential and John Hancock) also make their homes in the state.

This concentration of insurers appears to provide some evidence that the absence of price regulation makes Illinois an attractive business location for insurance. Moreover, because state officials don't spend time or resources regulating property and casualty insurance rates, more resources are available for fighting insurance fraud and addressing customer complaints. For that matter, Illinois officials also can redeploy saved resources elsewhere in the government or return them to the state's citizens through a tax cut.[31]

Why Other States Haven't Followed Illinois' Lead

Illinois' system has not been adopted by other states. Louis Winnick, writing in *City Journal*, proposes that "Rapid replication is perhaps the best market test of an innovation's real worth."[32] Even in government, some innovations have spread quickly: COMPSTAT for police management, community development corporations, and magnet schools, to name three well-known examples.

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[28] Stephen D'Arcy, supra, page 282.

[29] Ibid., page 273.

[30] David Cummins and Mary A. Weiss, "Regulation and the Automobile Insurance Crisis," *Regulation* 15 (2): 48–59.

[31] Of course, given the small size of any state's insurance department, it's not likely cutting an insurance department alone would lead to tax cuts.

[32] Louis Winnick, "Is Reinventing Government Enough?" *City Journal*, Summer 1993, http://www.city-journal.org/article01.php?aid=1470

One could argue that Illinois' benign system of insurance regulation is simply a case of "regulatory capture." Based on a personal communication with a former Illinois insurance commissioner, D'Arcy argues the state's status as home to State Farm and Allstate has helped maintain the status quo.[33] There's little doubt both companies would fight any effort to impose a more restrictive system in the state.

But regulatory capture can't explain why other states haven't adopted Illinois' hands-off approach. Illinois' property and casualty insurance market is only the seventh-largest in the country, according to A.M. Best. While the state's status as a "home office" for many companies certainly influences the legislature, it doesn't explain why other states with large insurance sectors (California and Connecticut, for example) haven't adopted a similar deregulatory approach. California, with the nation's largest insurance market, has some of the nation's most burdensome prior-approval laws, despite ongoing industry efforts to modify industry policies and procedures.

Thus, the question remains: Why haven't Illinois' regulatory methods spread further?

The answer, we hypothesize, lies in the accidental manner in which the system first arose. There's no evidence Illinois' elected officials had a particularly strong commitment to the free market. In fact, just as the no-file system was coming into effect during the 1970s, the state allowed its own state-run FAIR plan to become one of the state's largest insurers.[34] Illinois never passed a law specifically protecting insurers from regulation. Other states eyeing Illinois as a "model" would find no legislation here to adapt to their own circumstances.

A Strategy for Deregulation Elsewhere

Replicating Illinois' hands-off model will require a new strategy that includes drafting model legislation and making acceptable tradeoffs. Those tradeoffs may result in *increased* regulation in areas other than rates, so careful consideration of the tradeoffs would be merited.

Although dozens of model laws exist to modernize insurance regulation, none proposes a "no-file" system.[35] Illinois may be a model for how such a system can work in practice, but its insurance code does not offer specifics that other states could implement easily. State legislators seeking insurance regulatory reform could introduce no-file bills as a starting point.

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[33] D'Arcy, supra, page 257.

[34] Illinois FAIR Plan Association, supra.

[35] See e.g. American Legislative Exchange Council, "Property/Casualty Insurance Modernization Act," http://www.alec.org/5.html; and National Association of Insurance Commissioners, "Personal Lines Modernization Working Paper," August 2007.

In some states, it might prove prudent to transfer resources from auto and homeowners insurance rate regulation to areas where regulatory backlogs might exist, such as medical and workers' compensation insurance. In others, legislators might redeploy government employees to handle accusations of fraud, deal with consumer complaints, and oversee insurance company solvency.

Presenting a resource-shifting, rather than resource-eliminating, proposal would give legislators something to support and, presumably, would create a variety of constituencies willing to support a no-file system for reasons totally unrelated to its intrinsic merits.

8. Case Study: Texas

By Drew Thornley

The national trend toward a singular focus on affordable rates is not the key to a successful insurance market. Texas is a perfect example of the challenges this has created. As this trend has taken hold in Texas, it has led to a focus on preventing excessive rates, as embodied in the Insurance Code's prohibition on excessive rates and unreasonable profits.[36]

A healthier Texas insurance marketplace for consumers would emphasize fairness (ensuring that the cost to a policyholder reflects his level of risk) and solvency (ensuring that companies have the financial resources to pay claims). More companies enter the market, rates stabilize, and residual markets are smaller.

Texas's regulatory environment undermines insurers' ability to account adequately for costs and risk. Property and casualty insurers in the state cannot adjust rates based on market conditions. Ratepayers across the state are forced to subsidize homeowners and windstorm policies along the coast. Companies forced to offer below-market rates may be unable to cover claims against their policies, leaving many homeowners at risk.

Too Little, Too Late

Today's regulatory environment for insurance has grown out of the Texas "mold crisis" at the beginning of this decade. A 1999 lawsuit resulted in a 2001 finding that the Texas Department of Insurance's (TDI) standard form required insurers to cover mold claims. The number of such claims 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 of 2001 at $444.35. From 2000 to 2003, the number of companies writing homeowners policies in the state fell from 137 to 101. Consequently, premiums rapidly increased, though not nearly as fast as claims.

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[36] Sections 2251.051 and 2251.052, Texas Insurance Code.

Premiums increased by more than 40 percent in 2001 and 2002. All Texas homeowners had to pay higher rates, and many were forced into the residual market. 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 3) TDI's belated implementation of a 1997 provision allowing companies to use forms other than the standard state form.

Many observers say the mold crisis came to an end after the legislature rewrote insurance laws in 2003. But in fact, the change in forms allowed by TDI a year earlier made the difference.

In the 2003 rewrite of insurance laws, Senate Bill 14, the Texas Legislature removed the Lloyd's exemption—under which most companies had been able to set rates without regulatory oversight— and placed all companies under price regulation.

After an initial period during which all rates were subject to modification by the insurance commissioner, the legislation called for a new file-and-use regulatory system to be implemented in December 2004. However, the legislation contained a vague, subjective provision allowing the insurance commissioner to disapprove a rate, within 30 days of its filing, "if the commissioner determines that the rate does not comply with the requirements" of the law. If an insurer files and then uses a rate, the commissioner must go through the statutory hearing process for disapproving a rate in use.

As a result of these complexities, the intended benefits of a file-and-use system have not been fully realized in Texas. Texas's regulatory focus has remained on subjective notions of affordability and on regulatory intervention. Though Texas is a file-and-use state, the behavior of regulators and the regulated community at times makes the system operate as a *de facto* prior-approval system.

Rate Regulation in Action

In the summer of 2007, Farmers and Allstate withdrew proposed homeowners insurance rate filings in the face of TDI opposition. Subsequently, Allstate—Texas's second-largest homeowners insurance writer, with 600,000 policyholders—filed and used a 5.9 percent rate increase with TDI. Homeowners rates in certain coastal areas were to rise an additional 2.1 percent.

TDI tried to block Allstate from using the rate, but a Texas state district court judge rejected the bid on grounds that TDI did not provide Allstate with the proper 20-day notice. The situation was indicative of TDI's interference with insurance rate-setting.

Substantial Exposure

The inability of insurers to adjust for risk is especially evident with windstorm insurance. Created in 1971 in response to Hurricane Celia, the Texas Windstorm Insurance Association (TWIA) provides windstorm and hail coverage in Texas's 14 coastal counties and a few other designated areas. For years, TWIA's rates have been well below the level needed to cover losses from a major storm.

The accompanying table shows TWIA's rate filings with, and subsequent rate decisions by, TDI since January 1, 2003.

	Residential		Commercial	
Effective Date	**Filed**	**Approved**	**Filed**	**Approved**
1/1/2003	10%	0%	10%	10%
1/1/2004	10%	9.6%	10%	10%
1/1/2005	0%	0%	10%	10%
1/1/2006	10%	0%	10%	5%
9/1/2006	19%	3.1%	24%	8%
1/1/2007	18%	4.2%	20%	3.7%
2/1/2008	10%	8.2%	10%	5.4%

While TWIA is supposed to be a provider of last resort (i.e., a market for those unable to obtain insurance in the private marketplace), its below-market rates[37] have resulted in a dramatic increase in the number of policyholders and, thus, TWIA's exposure.

The number of TWIA policyholders has increased from 68,756 in 2001 to more than 216,008 at the end of December 2007.[38] As of November 30, 2007, TWIA's total exposure was $58,011,994,303.[39]

TWIA's current revenues can cover any losses up to approximately $45 million per year. If losses exceed that amount, the following funding system kicks in: (1) $100 million would be assessed to TWIA member insurers; (2) about $400 million would come from the Catastrophe Reserve Trust Fund and about $1 billion from re-insurance; (3) $200 million would be assessed to member insurers; and (4) unlimited assessment against member insurers, which could be recovered through state premium tax credits over five or more successive years.

A Rita-like hurricane strike on Galveston could expose TWIA to as much as $5 billion in claims, but funding measures (1), (2), and (3) provide just $1.7 billion. If more money were needed, it would come from the unlimited assessments against insurers, with the subsequent tax credits

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[37] Determining the "market" rate for windstorm insurance is difficult because of the heavy intervention in the market, the variety of policies being offered, and the lack of non-proprietary data sources. However, the rapid growth of the residual market is indicative of below-market pricing.

[38] Email from James C. Murphy, FCAS, MAAA, actuary, Texas Windstorm Insurance Association, January 8, 2008.

[39] Email from James C. Murphy, FCAS, MAAA, actuary, Texas Windstorm Insurance Association, December 4, 2007.

inflicting serious harm to the state's general revenue fund and taxpayers.

Beyond this substantial risk to taxpayers, rate regulation forces ratepayers across the state to subsidize homeowners and windstorm policies along the coast.

Steps Toward Reform

What can be done to modernize and improve Texas's insurance marketplace? Several options would improve the market for insurers, policyholders, and taxpayers.

First, Texas should deregulate the state's homeowners insurance market. In other markets, notably electricity and telecommunications, Texas has unleashed market forces with great success. The same success would result from allowing supply and demand to determine prices in the insurance market. Deregulation also would encourage investment and innovation, as it has in other competitive marketplaces in Texas. In a deregulated rate environment, more insurance carriers would enter the market, increasing insurance availability to consumers across the state.

Deregulating the insurance marketplace would reduce TDI's spending on licensing and regulating rates and forms (more than $20 million this biennium) and spending on administrative and technical support.

Secondly, fairness and solvency should guide insurance regulation. Regulators have no control over the underlying costs and risks associated with homeowners insurance, so they instead try to make determinations about rate "affordability." Those determinations are subjective, and it is impossible for regulators to promote fairness and solvency through such subjective rate determinations. Regulators turn to wealth redistribution through subsidized rates for high-risk consumers. Instead of pursuing affordability, TDI should implement policies that will allow insurers to pay claims and stay in the business of insuring.

Additionally, the legislature could adopt measures allowing Texans to purchase insurance from out-of-state insurers, similar to federal legislation addressing health insurance proposed in 2006. As added protection, the Texas legislation could ensure that Texans buying out-of-state policies are covered by Texas's consumer protection laws. Allowing Texas consumers to seek and purchase policies outside of the state would increase competition and provide Texans with more options to meet their insurance needs. Creating competition among Texas companies and out-of-state providers would benefit Texas consumers through more choices and lower prices.

Another option would be federal legislation creating optional federal charters, allowing insurers who choose to submit to federal regulation to offer policies in all 50 states. Under the proposed National Insurance Act, insurance companies operating under multiple state jurisdictions could choose to be regulated at the national level through an optional federal charter. Insurance companies could choose federal or state regulation. A federally licensed insurance carrier could sell insurance in any state, while state-licensed insurance carriers could sell insurance only

within the state(s) in which they hold licenses. State-licensed insurers would be free to convert to a national charter, and federally licensed insurers would be permitted to convert to a state charter.

A recent study on the optional federal charter conservatively estimated it would reduce costs for life insurers by more than $5.7 billion a year.[40]

Regarding the problems facing the Texas windstorm insurance marketplace, the most prudent course of action would be for Texas to make TWIA truly a provider of last resort. It should also be required to implement rates adequate to cover losses from a major storm and to differentiate rates based on risk. Making these changes would ensure a healthy windstorm insurance marketplace, one adequately funded to cover major losses and one where the state's general revenue fund and taxpayers are not on the hook for any unfunded liability.

Sunset Review Underway

TDI is currently undergoing review by the Texas Sunset Advisory Commission. The commission periodically evaluates Texas state agencies to determine if they are needed and are operating effectively, and if state funds are well spent. Based on the commission's recommendations, the legislature decides whether an agency continues operations.

The review process began in the fall of 2007 with a self-evaluation report by TDI.[41] The written public comment period ended last December, and public hearings are scheduled for June. The commission plans to release its recommendations to the legislature in September. The sunset staff will then work with the Texas Legislative Council to develop the recommendations into legislation to be considered by the legislature in 2009.

What the commission will examine at TDI is unknown, but its review could include the belated implementation of file-and-use, the use of questionable lawsuits and procedures in enforcement actions, and the effect of rate regulation on solvency.

Conclusion

The regulation of homeowners insurance in Texas has produced poor results for consumers, chief among them large swings in prices and availability. Regulatory uncertainty reduces investment and competition in the Texas insurance marketplace. Insurers assess risk years into

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[40] The study, sponsored by the American Council of Life Insurers, was released May 30, 2007 and was conducted by Steven Pottier, associate professor of insurance at The University of Georgia's Terry College of Business.

[41] http://www.sunset.state.tx.us/81streports/tdi/ser.pdf.

the future, but today they can't even predict what their income will be next year. This has a chilling effect on Texas's ability to attract capital and new insurers; over time, the absence of both will keep rates artificially inflated.

Rate regulation diverts resources from ensuring the solvency of companies. Much like TWIA, companies forced to offer below-market rates may be unable to cover claims against their policies, leaving many homeowners at risk of having no insurance at all.

The sunset review process provides the legislature an opportunity to end the department's role in rate regulation. The legislature should take full advantage of the sunset process, in order to make TDI a more effective organization in Texas's quest for a healthy insurance market.

Texas is generally a national leader in promoting limited government and unleashing market forces to bring investment and growth. However, insurance regulation in the state has tended toward regulatory intervention rather than free-market reforms. It's time for those days to end and for the days of a competitive, deregulated insurance market to begin.

9. Case Study: Vermont

By Ned Andrews, Esq.

One does not often associate Vermont—home of Howard Dean and government-run health care proposals—with a business-friendly, pro-competitive regulatory environment. But when it comes to the automotive and property casualty markets of the insurance sector, Vermont offers a very favorable climate.

This case study surveys the many laws and regulatory policies that make Vermont's market for homeowners and private passenger automotive insurance the third most competitive in the nation.[42]

Competition Recognized

Vermont "starts out on the right foot" in setting out the purpose of its laws. While most states, including Vermont, provide that insurance rates shall not be "excessive, inadequate or unfairly discriminatory," few acknowledge the importance of market forces in giving substance to those standards.

8 Vt. Stat. Sec. 4681, the Vermont legislature's statement of purpose for its system of rate regulation, seeks "to promote price competition among insurers so as to provide rates that are

[42] Based on an approximation of the Herfindahl-Hirschman Index. See the main report for an explanation of the methodology used to arrive at this ranking.

responsive to competitive market conditions" and "to cause the availability of price and other information to enable the public to purchase insurance suitable for their needs and to foster competitive insurance markets."

To be sure, these standards do not themselves enact pro-competitive policies, but in a system such as Vermont's, in which the legislature permits the insurance commissioner to make most substantive rules, such guidelines provide a welcome line of defense for insurers and would-be insureds whose ability to contract may be restricted by administrative over-reaching.

Use and File

Vermont by default employs a "use-and-file" basis for the setting of homeowners and automotive insurance rates (8 Vt. Stat. Sec. 4688(a)(1)). The exceptions to this default rule are that rates in noncompetitive and residual markets are set under a "file-and-use" system (Sec. 4688(c)(1)) and that filings by financially impaired insurers[43] are subject to prior approval (Sec. 4688(b)).

Sec. 4684 creates a presumption that the market for a given insurance product is competitive and therefore regulated under "use-and-file"; under Sec. 4685(b)(1), "[a] rate in a competitive market is not excessive or unfairly discriminatory" and therefore may not be rejected by the commissioner on those grounds. As a result, in the absence of extenuating circumstances, Vermont insurers' rate filings serve primarily to inform both the policy-holding public and competing insurers about the risks the filing insurers believe they face.

Although Vermont's insurance commissioner retains broad authority under Sec. 4684(a) to determine that the market for a given insurance product is noncompetitive—and therefore, practically speaking, to implement a "file-and-use" regulatory system for that product—several aspects of the determination procedure tilt the balance in favor of noninterference:

- Unless premiums for a given insurance product have increased by 25 percent or more over the past 12 months, the commissioner must give notice and hold hearings before finding that a noncompetitive market exists. 8 Vt. Stat. Sec. 4684(b)(1).

- Although the commissioner is by default obliged to hold hearings if the year-over-year increase in premiums is between 15 percent and 25 percent, he may refrain from doing so if he finds a competitive market exists. Sec. 4684(b)(2).

- Even if the year-over-year increase exceeds 25 percent, the commissioner is permitted to find a competitive market exists; Sec. 4684(b)(3) states only that he "may" issue a finding that the market is noncompetitive.

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[43] For rules and standards defining financial impairment, see Code of Vt. Rules 21-020-040(4).

- Finally, Sec. 4684(g) requires the commissioner to consider “the number of insurers actively engaged in providing coverage; market shares; and ease of entry” when deciding whether a competitive market exists. Although the weighting of these and other structural standards under Sec. 4684 and Sec. 4702 is left to the commissioner’s discretion, their enumeration provides specific grounds on which insurers can challenge his decision under Sec. 4707.

However broad the Vermont commissioner’s *de facto* authority to implement “file-and-use,” Vermont’s system is more conducive to competition than are state systems that set “file and use” (or even more restrictive regimes) as a starting point.

Consumer Freedom

Some Vermont statutes and regulations acknowledge that many beneficiaries and classes of beneficiaries are sophisticated in their ability to assess the risks they face, thus needing less protection than the default rules provide. For example, like many states, Vermont has enacted a provision (Code of Vt. Rule 21-020-016(III)(E)) allowing parties to contract for higher rates or more restricted coverage than those provided for in policies filed with the commissioner. Admittedly, this permission comes with strings attached: Rule 21-020-016(III)(E) subjects alternative coverage plans to a prior-approval regime.

The request for permission to contract for a higher rate or more restrictive scope of coverage must come from the prospective insured party; insurers cannot submit alternative policies and rates in advance for “fast-track” approval. The result is that parties are forced to go through the trouble of negotiating alternative terms without any guarantee that those terms will be acceptable to the commissioner. This effect becomes particularly bothersome in the aggregate: If a policy requires modification for a group of similarly situated customers who are numerous but not numerous enough to justify placing them in a separate risk category, they and their insurers must cut through the “red tape” person by person. (On the plus side, having the negotiation take place “up front” means the insurer and insured are likely working from the starting point of existing policies, in the process ensuring the insured is familiar with those policies and knows why he or she is a “bad risk” under them.)

Despite these limitations, such a system is better than a rigid, “all-or-nothing” scheme under which either a) the insured’s unusual risks are subsidized by members of the risk category most similar to his profile or b) the would-be insured must go without coverage of his otherwise-insurable risks because the unusual risks act as “deal-breakers.”

Code of Vermont Rule 21-020-016(III)(C)(6)(a) provides that casualty policies with deductibles of more than $250,000 that are not re-insured (i.e., not met using funds recovered under other policies) need not be filed at all. In all likelihood, an entity wealthy enough to meet such a high deductible without re-insurance has the financial sophistication to evaluate its exposure and the

suitability of a given policy without the commissioner's help. Of course, few if any homeowners policies are among the casualty policies with such high deductibles, but the enactment of this provision shows the Vermont legislature remains attentive to the general principle that many policyholders know what is best for them.

Residual Underwriting

Vermont's method of ensuring the availability of higher-risk coverage provides more opportunity for voluntary self-regulation than do the laws of most other states. Under the default rule of 8 Vt. Code Sec. 4694, Vermont insurers may but need not participate in residual underwriting programs; those programs are subject to prior approval and continuing review under Sec. 4692(b)(4).

In the case of property and casualty insurance, the commissioner may make participation in a residual underwriting program mandatory pursuant to Sec. 4696 if he determines upon investigation and hearing (see Sec. 4982(d)) that no voluntary market exists.

Even when the commissioner does require participation, however, Vermont law minimizes that participation's burden. 8 Vt. Code Sec. 4982(a) makes explicit that even mandatory-participation plans are intended to yield non-negative returns for the insurers administering them; though underwriting associations are chartered as nonprofit organizations (Sec. 4982(c)), each plan is intended "to provide insurance on a self-supporting basis without subsidy from its members" or the policyholders to whom the costs of subsidy would be passed. Sec. 4986 provides that policyholders under the plan, rather than participating insurers' other policyholders, must cover any operating deficits on pain of cancellation of their policies.

This system is similar but not identical to Maine's "market assistance plan" (see 24A Me. Code Sec. 2325-A) for non-automotive insurance. In addition to permitting voluntary residual underwriting associations, the Maine plan adds an intermediate step in which its insurance commissioner may require insurers to opt into a voluntary association or opt out and state their reasons.

In Maine's case, fully mandatory participation enters into play when the state insurance commissioner determines too many companies are opting out (see 24A Me. Code Sec. 2325-B). This more gradual approach gives companies some warning to engage in defensive self-regulation before the government steps in all the way.

In addition, Maine Sec. 2325-B(12) limits the lifetime of non-automotive mandatory shared-risk plans to two years unless the superintendent (what Maine calls its commissioner of insurance) extends them based on clear and convincing evidence of their necessity—a provision similar to

one found in competitive Connecticut (Gen. Stat. Conn. Sec. 38a-687(a)) and one from which the Vermont legislature could learn (contrast 8 Vt. Stat. Sec. 4992).

On the minus side, Maine law lacks any statement of intent that the shared-risk plan support itself. Indeed, Me. Code Sec. 2325-B(6)(E) anticipates insurers will suffer losses through the plan and requires the establishment of a procedure for pooling or re-insuring against those losses.

Willing to Innovate

Vermont has demonstrated a willingness to consider innovative approaches to insurance regulation. Most significantly for this paper's purposes, Vermont is a signatory to the Interstate Insurance Product Regulation Compact, codified as 8 Vt. Stat. ch. 165 (Sec. Sec. 8500-8517).

The compact, so far subscribed to by 30 states,[44] establishes a governing body permitted to review and approve filings from insurers in its signatory states.

Once an insurer obtains approval for a policy under the compact, it may immediately begin offering that policy in every signatory state in which it is licensed to transact business. Likewise, upon meeting a signatory state's other requirements to transact business, an insurer may expand operations under approved policies to that state immediately rather than waiting for that state to approve its filings.

By making it easier for an insurer doing business in one signatory state to do business in another, the compact encourages all such insurers to expand into all signatory states, increasing the number of participants in each state's markets.

In this respect, the compact bears some resemblance to the proposed National Insurance Act and its "optional federal charter," under which an insurer electing a federal charter and federal regulation may do business under the same standards in all states.

Another example of innovation worth mentioning is Vermont's leadership in the authorization and regulation of so-called captive insurance companies ("captives"). The simplest form of captive is a subsidiary dedicated to insuring against risks faced by its parent and/or sibling companies; other variations, such as joint ventures operated by multiple companies whose risks they manage, also exist.

Insurance via captives offers numerous advantages, most notably that in-house risk management gives parent companies the oporrtunity to reduce costs by capturing efficiency gains. Captive insurance thus serves as a substitute product against which outside insurance must compete, exerting downward pressure on traditional insurers' premiums.

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[44] See, e.g., http://www.insurancecompact.org/compact_faq.htm.

Vermont's 1981 legislation authorizing captives, currently codified as 8 Vt. Stat. ch. 141 (Sec. Sec. 6001-6048n), was the first domestic legislation permitting them even when insurance is available through traditional channels.[45] As of 2006, Vermont served as the leading U.S. corporate domicile for captives, hosting three times as many as Hawaii, the next-largest domicile.[46]

Vermont Lessons

Vermont's experience shows that insurance markets are capable of significant self-regulation: A high degree of competition can exist under the relatively loose regulatory control of a "use-and-file" system for competitive markets and a residual risk allocation system that is by default optional.

Vermont's example reinforces the common-sense observation that competition improves when regulations designed to promote the public welfare also treat businesses sensibly: Vermont's method of ensuring that insurers do not lose money on assigned risks removes a major disincentive to doing business in the state, thereby attracting market participants. By acting as a leader in the standardization of regulation, Vermont is working to reduce barriers to entry into its markets, and the success of its chosen method increases the likelihood that its leadership will have significant impact.

Finally, there is always room for improvement. In neighboring states, legislators have taken back control from insurance administrators by requiring timely review of commissioners' findings regarding noncompetitive markets and their accompanying assertion of regulatory authority. Though it is a relatively prudent regulator already, Vermont would be wiser still to do the same.

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[45] "Charting Vermont's captive insurance history," Business Insurance, August 7, 2006, available via http://goliath.ecnext.com/coms2/gi_0199-5713477/Charting-Vermont-s-captive-insurance.html. Colorado, Tennessee, and Virginia authorized some captives earlier. Colorado Captive Insurance Company Act of 1972, codified as former Colo. Rev. Stat. Sec. Sec. 10-6-101ff. (1973); [Tenn.] Acts 1978, ch. 616, codified as former Tenn. Code Sec. 56-4501ff.; and [Va.] Acts 1980, ch. 665, codified as former Va. Code Sec. 38.1-916ff. However, these states required that parent entities show an inability to procure insurance through traditional means before resorting to captives.

[46] Jerry Geisel, "A Top Domicile Rules," *Business Insurance*, August 7, 2006. http://www.vermontcaptive .com/Library/topdomicile.cfm.

10. Case Study: Louisiana

By Dan Sutter

On August 29, 2005, Hurricane Katrina dealt a devastating blow to Louisiana and to the state's property and casualty insurance market. In just a matter of hours, Katrina wiped out the past 25 years of homeowners insurance premiums and every dollar of profit made on homeowners insurance in Louisiana.

Such is the nature of catastrophe insurance. Damages from one event can reveal the inadequacy of premiums charged for decades. Unfortunately, Katrina and Rita will not be the last major hurricanes to strike Louisiana, and the potential for another devastating hurricane dominates the state's property and casualty insurance industry.

A state's environment for insurance, or any other good or service, is a product of natural and man-made forces. Louisiana's location on the Gulf Coast creates a vulnerability to hurricanes. As of 2004, 38 percent of insured property in the state was vulnerable to hurricanes, ranking it sixth nationally among coastal states.

Floods, Too

Nature creates substantial risk in the Louisiana property and casualty insurance environment, but two other factors add to the risk.

Any major hurricane that strikes Louisiana will almost certainly produce substantial flooding. Louisianans are aware of the flood risk, and the percentage of residents in coastal Louisiana parishes with flood insurance is high. Thus, a widespread lack of coverage for flood losses should not be a problem, as it was on the Mississippi coast with Hurricane Katrina. The state's residents, though, will likely have claims under both their homeowners and flood insurance policies in a future hurricane.

Katrina demonstrated the difficulties involved in distinguishing flood and wind damage, and this complexity increases the cost of insurance in several ways. For one, resources must be used to determine if water damage was due to wind or flooding, and this increases the cost of handling claims. A second consequence is delay in the payment of claims and rebuilding, which in turn increases how long policyholders must make alternate living arrangements and can increase the amount of loss (for example, through additional mold damage).

Finally, the Flood/No Flood allocation generates uncertainty for policyholders and insurers. Policyholders may be unsure with a major loss if they will be covered given the relatively low coverage limit on National Flood Insurance Program (NFIP) policies.

Insurers cannot know how the federal government will evaluate flood losses in the next hurricane. After Katrina, the NFIP initially took a relatively generous stance toward assuming losses, which consequently generated negative publicity and litigation as insurers were accused of shifting costs to the federal government. In a future hurricane, the federal government might take a very strict stance toward losses assigned to flood insurance.

Given continued subsidence of southern Louisiana, the potential for storm surge flooding is unlikely to disappear in the near future. The Coastal Protection and Restoration Authority may in time help restore the barrier islands and reduce storm surge flooding potential, but substantial help in this regard is probably years (or decades) away.

Institutional Factors

The second factor complicating the property and casualty environment in Louisiana is institutional: election of Louisiana's insurance commissioner. Direct election of the insurance commissioner, in contrast to appointment by the governor, makes insurance regulation more political, to the detriment of an economically sound insurance market.

Politics, of course, plays a role in the appointment of an insurance commissioner in states that have such a system. But governors make many decisions during their term, and relatively few voters will cast their vote for governor based solely on insurance issues.

Elected commissioners regulate to win favor with voters, and over time these policies create a dysfunctional insurance market. Consider how the insurance environment scores calculated for this report for states with elected commissioners compare to the scores for all states. Overall, the average score for all states is B, while for states with elected commissioners the average score is D.[47] The politicization of insurance policy produces a much less hospitable environment for business.

Encouraging Steps

Against this background of considerable uncertainty, Louisiana has taken some encouraging steps. Most notable was abolishing the Louisiana Insurance Rating Commission in 2007. The commission was the last of its kind in the U.S., a special politically appointed board with the power to approve and reject premium changes.

With the commission abolished, Louisiana now has a "file-and-use" system, in which an insurance company can file a rate change with the Louisiana Department of Insurance, and the

[47] The D average includes the score for Florida, which had an elected insurance commissioner until the duties of the commissioner were combined with the appointed chief financial officer in 2002. Thus Florida's environment has been shapely largely by the forces of direct election.

new rate becomes effective after 45 days unless reviewed and disapproved by the insurance commissioner. Flexibility for insurers in setting premiums is generally good for the market. Insurance companies should have broad discretion to set rates within the bounds imposed by solvency regulation, while competition between companies for customers can be relied upon to prevent rates from going too high.

The insurance commissioner still has the power to review and reject premium charges. With frequent use of this power, a file-and-use system becomes the equivalent of a prior-approval regulation. Abolishing the commission is nonetheless an important step, over and above simply having the commission regulate less, because it signals to the industry that Louisiana is changing the structure of its insurance market in the long term.

Another encouraging policy measure from 2007 was the Insure Louisiana Incentive Program, which offered $100 million in matching funds to insurers willing to enter the market or increase the amount of property insurance they write in Louisiana. Generally, offering subsidies to attract business to a state is a dubious proposition, and in a perfect world Louisiana should not pay companies to write insurance. But the alternative to a robust private market would be for Louisiana Citizens Property Insurance Corporation to permanently serve hurricane-exposed properties. Insure Louisiana should help increase competition in the market, and more vigorous competition is the alternative to regulatory premium setting. The incentive program directs Louisiana toward a market solution for property insurance, in sharp contrast to Florida's choice in 2007 of government-run insurance.

Property insurers in Louisiana face great uncertainty, much of it political and legal. An insurance company entering the state market now might face future assessments due to losses by Citizens, restrictions on rates or nonrenewal of policies, or the possibility of having to pay for flood damage after a future hurricane. The matching funds offered by Insure Louisiana offset some of this risk, and the program signals to insurers the state's long-run commitment to a genuine insurance market. After all, it would be foolish for the state to pay incentives to attract insurers now only to drive the companies out of the state with burdensome regulations in a few years.

Statewide Building Code

In December 2005, the state legislature passed the Louisiana State Uniform Construction Code, the first statewide building code. The code was strengthened in 2007 by adopting the 2006 International Residential Code and International Building Code.

Engineering estimates show strengthened construction can reduce wind damage by 40 percent or more. A building code, however, is not magic and will reduce damage only if builders who always build to or beyond the code benefit. Premium discounts for building stronger and more wind-resistant structures are important in providing owners an incentive to pay more to strengthen their buildings.

Act 323 of the 2007 legislature mandates that insurers must provide a discount or credit to policyholders whose building meets the Louisiana Uniform Construction Code, plus actuarially sound discounts for other wind mitigation measures. The Louisiana Department of Insurance is currently preparing regulations to implement this law.

Building to the Uniform Construction Code involves extra costs, and homeowners should rightly expect to share the benefits of reduced losses in the form of lower premiums. But government-mandated premium reductions can exceed the actuarially fair amount and thus become a disguise for subsidized premiums. Thus the base premium rate might accurately reflect the risk of hurricane damage, but excessive reductions for questionable types of mitigation could lead most policyholders to pay less than the fair rate for insurance coverage. Insurers should be free to offer discounts or incentives for mitigation, and if discounts are not regulated, competition in the market will lead to cost savings being passed on to consumers.

Homeowners need not worry that insurance companies will simply pocket the reduced losses from the Uniform Construction Code. Rather, insurers seeking to expand their market share will reduce premiums to reflect the lower expected costs for buildings constructed to the code. Insurers should be given broad discretion to craft incentives for mitigation.

Citizens Property Insurance Corporation

Louisiana Citizens Property Insurance Corporation has become the primary insurance writer in hurricane-vulnerable parts of the state. A large market share for the state insurance pool creates the potential for substantial assessments on policyholders or a taxpayer bailout in the event of another major hurricane.

In 2007, the state took two steps to shift some of Citizens' policies to private insurers. First, the Insure Louisiana Incentive Program requires that 25 percent of new policies written are for current Citizens' policyholders, and second, private insurers can now bid to acquire bundles of Citizens' policies.

While a small residual market is a good outcome, explicit policies to depopulate the state wind pool are an ill-advised method of attaining this goal. Florida paid subsidies to shift policyholders out of Florida Citizens in the early years of this decade. The Poe Insurance Group, which took on many of those policies, failed in 2006 following the hurricanes of 2004-05, and most of those policies were shifted back to Florida Citizens. The losses of an insolvent insurer are then passed on to other insurance companies and policyholders via the state guaranty fund. Florida reduced the number of policies in the state wind pool, but created a company that was not financially sound when the next hurricanes hit.

Simply paying to shift policies out of the wind pool does not create a sustainable insurance market. The size of a state's residual market is a reflection of the impact of state regulation on the insurance market. In a healthy insurance environment, a residual market or market of last

resort will have few customers. Explicitly shifting policies out of the residual market addresses a symptom—not the underlying causes—of a weak state insurance market.

Conclusion

Hurricane-prone states have faced a "crisis" in their property insurance markets in the past several years. Catastrophe risks are more difficult to evaluate and price for insurance purposes than ordinary losses. Thus, writing property insurance in Louisiana is never going to be a simple exercise.

But political and legal factors have combined with the underlying natural hazard to create an unnecessarily risky property insurance market in Louisiana. Since Hurricane Katrina, Louisiana has taken several steps to improve its insurance market, including abolishing the Louisiana Insurance Rating Commission and adopting a statewide building code. The Insure Louisiana Incentive Program signaled an interest in market-supplied property insurance as opposed to permanent reliance on Louisiana Citizens.

Louisiana's insurance environment received an "F" in this report, and clearly the state's insurance market is currently in poor shape. Recent developments, however, create cautious optimism that the Louisiana property insurance market will score better in the future.