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Property and Casualty Insurance 2009 Report Card

By Eli Lehrer and Michelle Minton*

1. Introduction

For the second year in a row, the Competitive Enterprise Institute and The Heartland Institute asked two fundamental questions about America's state insurance regulations:

- How free are consumers to choose the property and casualty insurance products they want?
- How free are insurers to provide the property and casualty insurance products consumers say they want?

> America's state-level insurance bureaucracies make it difficult – sometimes impossible – for insurers to offer consumers the products they need, want, and deserve.

Also for the second year in a row, we found a discouraging answer: not very free. America's state-level insurance bureaucracies make it difficult—sometimes impossible—for insurers to offer consumers the products they need, want, and deserve.

This study consists of four sections: this introduction, which describes why we are conducting this study; an explanation and defense of the methodology we used; a review of major changes in state insurance law during 2008; and, finally, the numerical ranking itself.

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We conducted this study for three reasons: because insurance is an important economic activity; because it is regulated almost entirely at the state level, resulting in significant variations of rules from state to state; and because we hope an objective look at state insurance regulation will encourage states to compete by creating freer environments for consumers and insurers.

Insurance produces considerable wealth and employment benefits. In 2007 (the most recent year for which data are available), America's property and casualty insurers charged premiums of almost $450 billion (according to the Insurance Services Office) and employed about 585,000 Americans. However, even before the beginning of the current recession, America's property and casualty insurance industry was shrinking. The 2006-2007 and 2007-2008 periods saw the first back-to-back declines in total property and casualty insurance industry revenue on record. Industry employment also has fallen and, when final 2008 numbers come in, it appears likely we will find the industry has shed around 30,000 jobs. More layoffs—at least 10,000—happened during early 2009.

Insurance is also the largest and most important economic activity regulated almost entirely at the state level. In some cases, this regulation leads to inefficiency. Although federal and international entities oversee banking, trade, manufacturing, and many service industries, states alone have the power to oversee property and casualty insurance ever since Congress approved the McCarran-Ferguson Act of 1945. As a result, insurers and consumers must deal with a confusing and expensive maze of state regulations. International insurers have a difficult time entering the United States market because they must enter each state market separately.

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State regulation makes insurance more expensive on average because incumbent insurers often lobby political authorities for rules that limit competition and allow them to raise rates. Consumers use their political influence as voters to support rate caps and subsidies to socialize the cost of insuring against risks they face due to the choices they make and should pay themselves. Both pressures lead to less consumer choice: Major property and casualty insurers have not introduced a single major new product since modern homeowners insurance (the HO-3 policy in industry parlance) became available in 1959.

No state does a perfect job of regulating insurance, but some do better than others. We produce this ranking to give states a sense of what they ought to do if they wish to free their insurance markets. We tried to collect data that show what states should—and shouldn't—do as they consider changes to their insurance regulatory environments.

We are conducting this study for the sake of consumers, elected officials, and individuals within the insurance industry (in that order). Its findings may not consistently reflect the opinions of those in the insurance industry or "consumer rights" advocacy groups and, indeed, may sometimes run directly counter to them. We believe an open and free insurance market maximizes the effectiveness of competition at fulfilling consumer desires.

Insurance is one of the key institutions that make economic prosperity possible. Properly designed, insurance makes the management of risk possible and, in so doing, makes long-term planning and investment possible. Insurance markets best accomplish their risk-management function when insurers are allowed to charge actuarially determined rates that accurately reflect the risk their policyholders incur.

When government regulation interferes with these price mechanisms, the result is either rate suppression or a redistribution of the cost burden, resulting in a wealth transfer from policyholders who behave prudently to those who take greater risks. Political manipulation of insurance rates, regardless of its intentions, distorts the competitive signals of the private market and reduces the range of products available for consumers. Price controls inevitably reduce the supply and lower the quality of insurance products.

Government plays an important and necessary role in regulating insurance. Laws against force and fraud in the insurance business, for example, clearly are needed, and their enforcement belongs in the hands of the state. Enforcement of reserve requirements, timely response to claims, and requiring the use of clear language in insurance contracts are all legitimate government functions that benefit consumers.

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The current regulatory environment in many states, however, goes far beyond this limited role. It is characterized by heavy-handed regulation through processes that are generally unknown by the general public and dominated by special-interest groups and a small number of elected officials. This process imposes large, though undocumented, costs on businesses and individuals deprived of reliable and affordable insurance products. The regulatory burden increasingly threatens to put U.S.-based financial services companies at a competitive disadvantage with those in Europe. We believe most decisions—especially the price charged for insurance products—should remain largely in the hands of market forces and voluntary arrangements.

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

Additional opportunities for reform exist in many states but are not highlighted by our methodology. If a state with reasonable insurance laws under-staffs its insurance department, so that consumers with fraud complaints and companies wishing to file rates cannot get timely assistance, then there is a need for reform that would not be revealed by our methodology. A state that favors in-state (domestic) insurers over those operating elsewhere may likewise create a seemingly "competitive" market without a very level playing field. Our methodology does not make these distinctions.

2. Methodology

We assess 11 variables. In all but one case—where the nature of the data dictates a multi-year approach—we use the most recent one-year data available. We use a mix of 2007 and 2008 data depending on what we had available.

For most variables, 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 reflect a lack of regulations, only that a state is typical of the country as a whole. When we scored actions, policies, and environmental characteristics as “pro-free market” we added points. Conversely, we subtracted points for “anti-free market” actions.

We weighted variables based on their importance to preserving a free and competitive marketplace and gave greater weight to those variables that matter most to consumers.

We weighted variables based on their importance to preserving a free and competitive marketplace and gave greater weight to those variables that matter most to consumers. Things that are mostly affairs of insurers—political control of insurance departments and regulatory inconsistency—received modest weightings. Things that reflect consumer experiences—residual market size and market concentration—were more heavily weighted. Although we attempt to rank overall levels of freedom for consumers, political leaders, and insurers, our study gives an “edge” to the factors most important to consumers.

This weighting process materially affects some states’ ratings. The significant inflow of new insurance companies into North Carolina’s automobile insurance market, for example, indicates the market appears to serve business well. The state ranks low in our scheme, however, because it scores poorly according to other, more consumer-centric, factors.

Any objective rating must apply the same criteria to each item being rated. This requirement, though, can cause a rating system to miss important differences among the things being rated. To begin with, we are limited to quantifiable data we could find, create, or compile for all 50 states. For example, we were unable to collect systematic data about the quality of state programs intended to investigate force and fraud in the insurance industry. We would have liked to include such data but simply couldn’t identify good sources or an objective way to weigh it.

We also tried to focus on laws and regulations and situations common to, at minimum, a great part of the country. States that encourage residents to secure their property against storms—as Florida and South Carolina do—do something important for their insurance consumers. But because only a handful of states have a need to provide such encouragement, we don’t award Florida or South Carolina extra points even though these regulations might be considered “good.”

Our results are not directly comparable to last year's but rather represent our current thinking as to the best method of ranking state insurance environments. We changed our methodology in response to discussions with colleagues and comments from regulators, the industry, and insurance consumers.

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1. We reduced the weight granted to residual market factors. Residual markets serve consumers for whom state government officials believe coverage in the private market cannot be found at a "reasonable" price. Although we consider residual markets the greatest threat to insurance freedom, our previous methodology guaranteed terrible grades to any state that maintained even one large residual market. This year, we've capped the penalty applied to any residual market mechanism so as not to give it undue weight. (States with the biggest residual markets still landed at the bottom of our rankings.)

2. We removed a category devoted to insurance form regulation. We do believe form regulation matters, but we're not convinced we can discern much by looking at the nature of state form regulatory laws. Quite often, the significance of form regulation depends more on state custom and rather than on statute or regulations.

3. We reduced the relative weight given to credit scoring and territorial ranking.

4. We've added a "regulatory clarity" category, which downgrades states that do not apply rules clearly and consistently.

5. We added an "auto market entry/exit" category that rewards states that are facilitating competition by allowing more companies to enter the market and penalizes states that have driven business away.

6. We've added a "political oversight" category and downgraded states with elected insurance commissioners. We assigned this category minimal weight.

7. We added "pluses and minuses" to our grades.

8. We continue to include Washington, DC in our ranking but, because its market—a single city—is intrinsically different from that of other states, we do not assign it a letter grade.

3. Variables

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

Political Oversight

Overseeing insurance rates is a heavily technocratic task that ought to consist mostly of monitoring companies for solvency and preventing fraud. The task involves law enforcement and effective and efficient management of compliance systems. Putting insurance rate regulation in the hands of an elected insurance commissioner has a tendency to politicize a job that has far more to do with spreadsheets than politics. We realize it is necessary and valuable for the people to have oversight over their government's activities, but we believe this is best exercised by representatives and governors who oversee insurance regulation as part of their responsibility to oversee all state regulatory activities.

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We used information from the National Association of Insurance Commissioners to identify states with elected insurance commissioners, and we subtracted 2 points from their scores. Florida elects a chief financial officer who has some indirect authority over insurance regulation but, because the insurance commissioner has a large degree of autonomy, we did not penalize that state.

Regulatory Clarity (Desk Drawer Rules)

Effective insurance regulation requires consistency and clear rules. We penalized states that, based on a survey of insurance industry regulatory liaisons, appeared to require filings under unclear rules—"desk drawer rules" in industry parlance. The complaints differ but the fundamental charge is the same: the states administer insurance laws arbitrarily. Each state found using "desk drawer rules" (based on at least two independent reports) receive a score of -5.

A lack of regulatory clarity undermines the fundamental principle that like cases should receive like treatment and different cases should receive different treatment. When a state sets deadlines arbitrarily or doesn't define what it wants insurers to file with their paperwork, it makes product innovation impossible. Note that we penalized states for failing to make their rules clear—not for having bad rules per se. The fact that a rule is unclear does not make it bad.

California, for example, receives a "desk drawer rules" penalty because it allows insurance department analysts to set their own deadlines for responses to requests rather than establishing a response deadline through statute or regulation. It's likely that at least some analysts set perfectly reasonable deadlines for responses. Of course, that isn't the point. The point is that California allows analysts arbitrarily to define something that really ought to be a matter of statute or regulation. Likewise, many insurers complain Florida requires a plethora of data in different forms than other states. State publications, however, clearly spell out the data Florida requires. Thus, Florida did not receive a penalty even though its rules may be unnecessarily onerous.

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; one state (North Carolina) runs a very large semi-private "shared" auto insurance market. Most residual markets involve coalitions of private companies required by law to write insurance at rates determined through a politically imposed process.

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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 2007. Although many 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. Thus, for all intents and purposes, all pools are government-supported enterprises that will be bailed out if they get into trouble.

Using data from the Automobile Insurance Plans Service Office (AIPSO) and the Property Insurance Plans Service Office (PIPSO) (which provide national services for residual property and automobile plans), we measured the size of residual markets for automobile and homeowners insurance. When we had figures more recent than AIPSO and PIPSO provided—as we did for several states—we used them instead.

Residual markets represent a state subsidy for policyholders who take risks the free market is unwilling to absorb without higher premiums or some other form of compensation. The existence of large 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 one-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 that assigned more than 1 percent of policies to the residual market, we subtracted points equal to the percentage in the residual market plus 1. (In other words, a state with 2 percent of consumers written in the residual market would receive a score of -3.) We "capped" reductions in each category at -10 to avoid distortions in the overall scores.

Some examples of the scores: South Carolina writes four policies in its residual automobile insurance market and received a score of zero in this category. Vermont maintains a smaller residual market that includes about .7 percent of the states' drivers, so it received a score of -1. New Jersey's market includes about 3 percent of that state's drivers, so it received a score of -4. North Carolina, home to the largest residual auto insurance market in the country, insures about 21 percent of its drivers through the state-mandated privately run Reinsurance Facility. It received a score of -10.

Market Volatility

Highly volatile markets make things difficult for consumers and insurers and often are the result of regulatory interference or uncertainty. If an insurer sees wildly whipsawing profit margins, it will probably not work to cut prices or attract new consumers. As a result, volatility hurts consumers: It tends to reduce the amount of competition in a state (insurers want to know what they are getting into) and will often make companies reluctant to cut prices even when costs decline.

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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. We excluded homeowners insurance from this calculation. 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.

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 10 states with the largest deviations (that is, the most volatility) received a score of -5 and the next five highest received a score of -3. The 10 middle-scoring states received a 0 score. The five states with the smallest deviations received a score of 5, and the next five states with the smallest deviations 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 2008 market data collected by AM Best. Using the Herfindahl-Hirschman Index (HHI), the widely accepted standard for measuring market concentration, we computed the market share percentages for all insurance companies in the market. 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.

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.

Idaho is an example of a state that scored high in our market competition measure: Although it has a small population, a mix of national, regional, and Idaho-centric companies gives its residents a plethora of choices for automobile and homeowners insurance. Alaska, by contrast, had highly concentrated automobile and homeowners insurance markets. Perhaps because it is so remote, only a handful of companies wrote significant numbers of policies there.

In each category, we gave the 10 most-concentrated states a score of -5 and the 10 next-most concentrated a -3. The middle 10 received a score of 0. The 10 least-concentrated states received a score of 5, and the 10 next least-concentrated states received a score of 3.
We scored homeowners and automobile markets separately because different types of regulations may affect the two markets. Overall market concentration is scored in a range of -10 to +10 points.

Auto Insurance Market Entry

A strong auto insurance market attracts new competitors. Using AM Best data, we calculated market entry and exit during 2007. States received one point for each firm that entered the market and lost one point for each that left the automobile insurance market.

Because some state laws sometimes significantly restrict companies' ability to leave homeowners insurance markets and because the nature of homeowners insurance contracts makes it difficult to exit a market altogether in short order, we did not score homeowners insurance entry and exit.

Rate Regulation

Forty-eight states impose a significant 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.

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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 either "file-and-use" or "flex-rating" systems received a score of 0.

Other states require regulators to pre-approve all rates. Such "prior-approval" regulation, found in states like New Jersey and North Carolina, 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 more difficult, insurers tend to request larger increases (and rate cuts) when they change the rates being charged. States with prior-approval laws received a score of -10. When we found media reports indicating the rejection of rates prior to their use—which we found in Texas and Washington—we graded the state as prior approval even though those states have "file-and-use" laws on the books. A few states, like Massachusetts, that have prior approval in one area but not in another received a score of -5.

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.

Other states, such as Vermont and Idaho, 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 to be excessive. These states were scored 10.

Two states, Illinois and Wyoming, operate under no-file or modified no-file systems. 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 greater freedom than any other, and thus Illinois and Wyoming received scores of 20.

One state, Florida, establishes rates through the political process. Florida operates a state agency, the Citizens Property Insurance Corporation (Citizens), which will sell insurance to anybody who receives a single insurance quote more than 15 percent above Citizens' rates. Florida received a score of -20 for this practice. Some may contend that North Carolina's burdensome system of bureau-defined rates—which have created an enormous residual automobile insurance market—amounts to government-set rates. While the rate process does seem both anachronistic and unnecessarily complex, it does not result in wholesale political establishment of the rates. As a result, we graded it as a -10.

Credit Scoring

Because credit scores are widely available and reasonably reliable for determining risk factors, insurance companies consider them valuable for setting rates. States that allow the use of credit scores generally have lower overall rates than those that forbid them. 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 entirely the use of credit scoring, or impose restrictions so severe credit scoring becomes useless, received a score of -5.

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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 the sole factor in determining insurance rates. No company uses such scores as the sole factor, so this legal restriction has no real meaning.

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.

Although no state makes it impossible to use geography in any way, many states place a significant limitation on the places insurance companies operate. Michigan, for example, mandates "automobile and home insurance risks must not be grouped by territory and automobile and home insurance rates must not be based in whole or in part on territory or location of risk." Michigan and states with similar provisions received a score of -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. In some cases, where we found regulations that appeared to significantly limit the use of territorial rating (despite laws similar to those elsewhere in the country) we graded the state with a negative -5.

We awarded pluses and minuses within each gradation to recognize states at the top and bottom of each gradation.

Finally, some states have no territorial rating restrictions at all. These states received a score of 5. (One state, Washington, has no territorial rating law but does perform some oversight of the use of geographic factors via other regulations, so it also received a zero.)

4. Assigning Grades

We calculated scores for every state by adding all variables and calculating a standard deviation from the mean. (The mean was -2.) States were graded as follows:

A More than one standard deviation above the mean. No state received an A+ or A-.

B More than half of one standard deviation above the mean but less than a full standard deviation above the mean.

C Above the mean by less than one half of one standard deviation.

D Below the mean by one standard deviation but less than one-and-a-half standard deviations. Because we did not give a grade of F+, we expanded this range.

F Below the mean by more than one-and-a-half standard deviations.

We awarded pluses and minuses within each gradation to recognize states at the top and bottom of each gradation

5. State Scores

The table on the following two pages presents the scores for all 50 states and the District of Columbia on each of the 11 variables and the resulting letter score.

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

State	Letter Grade	Score	Political Oversight	Desk Drawer Rules	Residual Auto	Market Entry Auto	Residual Homeowners	Market Concentration Auto	Market Concentration Home	Loss Ratio Stability	Regulatory Environment	Credit Scores	Territorial Restrictions
Alabama	D+	**-9**	**0**	**0**	0	-3	0	-3	-3	5	-10	0	5
Alaska	D+	**-7**	**0**	**0**	0	-2	0	-5	-5	0	0	0	5
Arizona	A	**23**	**0**	**0**	0	3	0	5	5	0	10	0	0
Arkansas	C	**2**	**0**	**0**	0	2	0	0	0	0	0	0	0
California	D	**-12**	**-2**	**-5**	0	5	0	5	5	0	-10	-5	-5
Colorado	D-	**-18**	**0**	**0**	0	-2	0	-3	-3	-5	0	0	-5
Connecticut	C+	**7**	**0**	**-5**	0	2	0	5	5	5	0	0	-5
Delaware	D+	**-9**	**-2**	**0**	0	3	0	-5	-5	0	0	0	0
District of Columbia	N/A	**-10**	**0**	**0**	-2	2	0	-5	-5	0	0	0	0
Florida	F-	**-36**	**0**	**0**	0	-1	-10	0	0	0	-20	0	-5
Georgia	D+	**-3**	**-2**	**-5**	0	5	-1	0	0	0	0	0	0
Hawaii	F	**-28**	**0**	**0**	-2	-1	0	-5	-5	0	-10	-5	0
Idaho	A	**25**	**0**	**0**	0	0	0	5	5	0	10	0	5
Illinois	B+	**14**	**0**	**0**	0	4	0	-5	-5	0	20	0	0
Indiana	B	**12**	**0**	**0**	0	6	0	3	3	0	0	0	0
Iowa	C+	**7**	**0**	**0**	0	1	0	3	3	0	0	0	0
Kansas	C-	**-1**	**-2**	**0**	0	1	0	0	0	0	0	0	0
Kentucky	C	**0**	**0**	**0**	0	2	-1	-3	-3	-5	10	0	0
Louisiana	F-	**-37**	**-2**	**-5**	0	2	-2	-5	-5	-5	-10	0	-5
Maine	B-	**10**	**0**	**0**	0	5	0	5	5	0	-5	0	0
Maryland	F	**-30**	**0**	**0**	-3	3	0	-5	-5	0	-10	-5	-5
Massachusetts	F-	**-35**	**0**	**0**	-5	7	-7	-5	-5	-5	-10	-5	0
Michigan	C	**1**	**0**	**0**	0	3	-3	3	3	0	0	0	-5
Minnesota	C	**2**	**0**	**0**	0	2	0	0	0	0	0	0	0
Mississippi	D-	**-20**	**-2**	**0**	0	3	-1	-5	-5	-5	-10	0	5
Missouri	C	**0**	**0**	**0**	0	1	0	-3	-3	0	10	0	-5
Montana	C+	**4**	**-2**	**0**	0	0	0	3	3	0	0	0	0
Nebraska	B-	**10**	**0**	**0**	0	6	0	-3	-3	0	10	0	0

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Nevada	B	**12**	**0**	**0**	0	7	0	5	5	5	-10	0	0
New Hampshire	B+	**15**	**0**	**0**	0	5	0	5	5	5	0	0	-5
New Jersey	C-	**-1**	**0**	**0**	-4	8	-1	3	3	0	-5	0	-5
New Mexico	C	**2**	**0**	**0**	0	3	-1	0	0	5	-10	0	5
New York	F	**-27**	**0**	**-5**	-5	4	0	-3	-3	0	-10	0	-5
North Carolina	D-	**-18**	**-2**	**0**	-10	7	-3	0	0	0	-10	0	0
North Dakota	B-	**8**	**-2**	**0**	0	0	0	5	5	0	0	0	0
Ohio	B+	**14**	**0**	**0**	0	4	-1	3	3	5	0	0	0
Oklahoma	C-	**-2**	**-2**	**0**	0	6	0	-3	-3	5	0	0	-5
Oregon	C	**0**	**0**	**0**	0	5	0	0	0	0	0	0	-5
Pennsylvania	D-	**-15**	**0**	**-5**	-1	1	0	0	0	5	-10	0	-5
Rhode Island	D	**-11**	**0**	**0**	-7	2	-7	3	3	0	0	0	-5
South Carolina	C+	**3**	**0**	**0**	0	4	0	-3	-3	0	5	0	0
South Dakota	C+	**3**	**0**	**0**	0	2	0	3	3	-5	0	0	0
Tennessee	D+	**-10**	**0**	**-5**	0	6	0	-3	-3	0	-10	0	5
Texas	D	**-12**	**0**	**0**	0	1	-3	0	0	0	-5	0	-5
Utah	A	**27**	**0**	**0**	0	6	0	3	3	0	10	0	5
Vermont	A	**28**	**0**	**0**	-1	4	0	5	5	0	10	0	5
Virginia	B+	**13**	**0**	**0**	0	4	-1	0	0	0	5	0	5
Washington	C-	**-2**	**-2**	**-5**	0	5	0	5	5	5	-10	-5	0
West Virginia	D-	**-18**	**0**	**0**	0	2	0	-5	-5	0	-10	0	0
Wisconsin	C	**1**	**0**	**0**	0	2	0	-3	-3	-5	10	0	0
Wyoming	B+	**13**	**0**	**0**	0	4	0	-3	-3	-5	20	0	0
Mean		**-2.2549**											
Standard Deviation		15.9998											

6. Discussion of Results

The report card paints a grim picture of America's insurance environments. Only four states—none of them particularly large—received the A grade. Arizona, the largest state to receive an "A" grade, has a population of only about 6 million. The four largest states—California, Texas, New York, and Florida—all received Ds or Fs.

On the whole, freedom to buy and sell insurance exists in only a few places in the United States. Most Americans cannot buy the insurance products they want and most states make it impossible for insurers to sell them. The discussion below describes a typical state that received each letter grade.

> On the whole, freedom to buy and sell insurance exists in only a few small islands.

Vermont, for the second straight year, landed atop our rankings. The small state does many things right. It maintains competitive markets for all types of insurance, attracts new companies, and allows insurers to use territorial factors to determine rates. Vermont is a haven for home-grown insurance companies: Every nationally recognized insurance company does business there, and these national providers compete vigorously for market share with a number of Vermont-focused companies.

Illinois, which insurance industry insiders often cite as a good place to do business (thanks to the state's lack of price regulation) received a B+. Although the state does allow pricing freedom—and receives a suitable reward—its market remains very concentrated and consumers have relatively few choices in some areas. The state is home to the two largest property and casualty insurers in the country, State Farm and Allstate. This concentration of large insurance companies instate has made it difficult for smaller insurers to compete in what is the literal backyard of two industry giants. This high degree of market concentration may stem from state policies not noted in our rankings that make it difficult to compare insurance rates within the boundaries of the City of Chicago.

Wyoming received a B+. As the smallest state by population—it has fewer people than Washington, D.C.—it rarely registers on people's radar screens. By all rights it should probably have received an "A," but it had points deducted for both its concentrated market and the high fluctuations of insurers' loss ratios. Both are probably to be expected in a small state.

Nevada represents a typical "B" state. Its environment is above-average in many ways: Companies appear willing to do business there—its market appears almost as competitive as Vermont's—and they enjoy stable loss ratios (indicating regulatory consistency). On the other hand, the state regulates rates through a burdensome prior-approval process.

Nebraska, which received a B-, probably gets treated unfairly in these rankings. It has few, if any, unusually burdensome laws. However, it has points deducted for its rather concentrated market. It's quite likely, however, that the concentration of Nebraska's market stems from the state's physical isolation, relatively small population, and the presence of a large locally owned (although not locally based) insurer.

Connecticut, a C+ state, does some things well. Like residents of all New England states, people in Connecticut enjoy a highly competitive insurance environment, and loss ratios show a degree of consistency. Insurers, however, complain about heavy use of "desk drawer" rules and an insurance department that sometimes misses its self-imposed deadlines for no apparent reason.

Michigan's C grade, by contrast, reflects an insurance environment that gets worse by the day. Although the state faces no risk of hurricanes or earthquakes—events that may, in some cases, prove uninsurable through conventional market mechanisms—it maintains a sizeable residual homeowners insurance market. No other inland state does so. Likewise, the legislature has recently put into place a ban on the use of most territorial rating in insurance prices. Michigan consumers have a moderately good choice of carriers, mostly because many companies want to minimize their exposure. Not surprisingly, Michigan residents pay high rates for some types of coverage (in the City of Detroit, a basic automobile insurance policy costs more than $6,000 a year.)

New Jersey, despite being ranked near the bottom of our rankings with a C-, has shown signs of a fast-improving insurance environment. It has attracted a number of new auto insurers in the wake of reforms that ended what was previously heavy-handed government oversight of auto insurance rates. On the other hand, it still maintains overgrown residual markets and continues to exercise some control over rates.

New Jersey, despite being ranked near the bottom of our rankings with a C-, has shown signs of a fast-improving insurance environment.

Georgia received a D+. Insurers criticize the state's heavy use of "desk drawer rules"—during our study we received more reports about Georgia than any other state—and its politicized insurance environment. During 2008, the state shifted to a file-and-use system for automobile insurance rates, and this is reflected in the state's rating. With its old prior-approval system, the state would have received a lower grade.

California received a grade of D. The state currently does little right. Its market appears competitive, but this is more a result of the sheer size of the state than an effective regulatory system. As an example, the state's auto insurance rates—determined through a burdensome prior-approval process—bear little relationship to risk. On the whole, California has rigged its insurance system to favor males and those who live in high-density areas at the expense of females and those who live in low-density areas. It remains the only state to have most of its automobile insurance rules approved by referendum—a sign the process has become too politicized.

Texas also received a grade of D. Although the state has a "file-and-use" law on the books, the insurance commissioner sometimes rejects rates (usually from larger companies) before they are filed. In addition, the state bars most types of territorial rating. Texas consumers pay some of the highest insurance prices in the nation while simultaneously having few insurance providers to choose from—particularly for residents of a larger state. Texas is also currently facing worrisome growth in its state-mandated wind pool.

North Carolina received a D- largely, although not entirely, due to the state's antiquated and unfair auto insurance system. The system, which borders on government price control, has shifted a significant percentage of the state's drivers to a state-mandated "reinsurance facility." North Carolina also has experienced worrisome growth in the size of its state wind pool. Insurance commissioner Wayne Goodwin has vowed reform of the pool; in time, the state's grade may improve.

Florida received an F-, the lowest overall grade in our survey. A free market for homeowners insurance does not exist in Florida. Instead, a state-run agency, the Florida Citizens Property Insurance Corporation, serves as the state's largest property insurer. Florida's rate regulatory system is one of price control. Currently, Florida limits all insurance rates to Citizens' rates plus 15 percent. The state's burdensome prior-approval process and wholesale government interference with the rate-setting process has led most major insurers to withdraw or cutback policy-writing in the Florida market.

7. 2008 in Review: Trends in Regulation

During 2008, America's property and casualty insurance industry found itself caught up in the turmoil that roiled the world's financial services markets. Four trends emerged during 2008 that seem likely to shape the nature of insurance regulation in 2009 and for years to come: increased federal regulation, a shift away from stock-based ownership of insurers, significant growth of state-level residual wind markets, and continuing free-market trends in automobile insurance.

The federal government, which had traditionally played a modest role in insurance markets, asserted itself during 2008 when it bailed out the nation's largest insurance company, began regulating credit default swaps, and established a Troubled Assets Relief Program (TARP) that could make the federal government a universal "insurer of last resort."

The federal government, which had traditionally played a modest role in insurance markets, asserted itself during 2008.

The bailout made the most news: Following a series of losses apparently resulting from a variety of credit insurance transactions, American International Group (AIG) teetered on the brink of insolvency. In return for a credit facility from the U.S. Department of the Treasury and the Federal Reserve Bank of New York of nearly $130 billion, AIG sold nearly 80 percent of its equity to the federal government.

AIG's labyrinthine 72-subsidiary structure meant that as of early 2009, few analysts knew exactly which parts of the company will prove stable. The structure has few parallels elsewhere in the industry. State Farm, which serves more individual property and casualty customers in the U.S., consists of only 12 subsidiaries.

The Securities and Exchange Commission, under considerable controversy, brought credit default swaps—insurance-like instruments largely used for bonds—under its purview. The SEC's action ended a plan offered by New York State Insurance Superintendent Eric Dinallo to regulate these instruments at the state level. The SEC's move will have little immediate consequence for the property and casualty insurance market, but it does give the federal government a "foot in the door" for regulation of the insurance industry.

The federal government introduced TARP as part of the Emergency Economic Stabilization Act (EESA). Although intended largely to help troubled banks and investment firms, TARP creates a permanent, affirmative obligation for the federal government to provide "economic stability," a phrase never explicitly defined. If a major catastrophic event were to occur that caused the simultaneous failure of several major insurers, it appears almost certain the federal government would use its new authority under EESA to intervene and bail out the insurer.

> The single broadest proposal to revise insurance regulation—Optional Federal Charter—received bipartisan support in both the House and the Senate but never came to the floor for a vote.

Coinciding with the growth in federal regulation, the long-standing trend of growth-favoring publicly held insurance companies reversed itself in 2008. AIG, a publicly owned company, needed a bailout to remain solvent and Allstate, which offers more personal lines of property and casualty coverage than any other insurer, announced a third-quarter loss of $3.1 billion. This slowdown was not universal. A few large publicly held companies—Chubb among them—emerged mostly unscathed. Although final results from last year are not yet available, mutually owned insurance companies and other non-stock companies appear to have experienced milder losses. As a result, a modest shift towards mutual ownership of insurance companies appears likely to continue.

Proposals for wholesale change in the insurance industry gained little traction. The single broadest proposal to revise insurance regulation—the optional federal charter—received bipartisan support in both the House and the Senate but never came to the floor for a vote. Under the OFC proposal, insurance companies would have been permitted to choose to be regulated by the federal government. The federal government would have regulated forms and solvency, but would have permitted insurers to set their own rates. As Congress now seeks to increase insurance company regulation, however, the proposal appears dead.

In early 2009, the chief proponents of OFC introduced a new proposal—The "National Insurance Consumer Protection and Regulatory Modernization Act"– that shared some features with the earlier OFC plan. The new proposal, while still free of rate regulation, contains bureaucratic and regulatory features the former one lacked. For example, it would establish an office in each of the 50 states and would remove the "optional" nature of the federal charter: Companies the government deems "systemically important" can be forced into federal regulation without their consent.

State regulation in homeowners and auto insurance, the two fields we studied, saw two major trends: a freeing-up of auto markets and growing government intervention in wind insurance markets.

Governments appear more willing than they have been in the past to let free-market forces work in auto insurance markets. During 2008, Massachusetts ended its practice of dictating auto insurance rates directly. In Georgia, regulators switched the auto insurance system rating method from a burdensome prior-approval system to a less-burdensome file-and-use system, against the objections of the state's elected insurance commissioner.

Governments appear more willing than they have been in the past to let free-market forces work in auto insurance markets.

The number of residual auto insurance markets also shrank nationally. By the end of 2008, only seven states reported more than 1 percent of drivers in a residual auto insurance market. In all but two of those states, the residual market shrank overall. And for perhaps the first time since modern residual markets emerged in the 1960s, state residual automobile insurance pools in a majority of states (26) covered almost no drivers (totaling less than one-tenth of 1 percent of all motorists). State insurance overseers, in short, have come to realize the free market provides affordable auto insurance more effectively than the government can.

By contrast, wind pools continued their worrisome growth in many states. Mississippi, North Carolina, South Carolina, and Texas all saw significant growth in their wind pools. Florida's wind pool shrank on paper, but most of those losses came through a subsidized program that was designed to attract new insurers to the state. These new Florida-only insurance companies were lightly capitalized, and they will be heavily reliant on the state-run Florida Hurricane Catastrophe Fund in the event of a major storm. (Since Florida already received the worst-possible score for its wind pool, we did not take this into account in the rating.) It appears the government has, for all intents and purposes, assumed at least half of Florida's overall property insurance liability.

At least three factors appear to be driving the growth in state wind pools: rate suppression, industry skittishness, and a general lack of interest in before-the-fact damage mitigation.

Most state regulators have proven unwilling to allow market forces to dictate insurance rates, preferring to interfere in that process by suppressing or otherwise controlling rates. Many insurers simply do not believe they can obtain a sufficient return on their equity by writing policies in states, like Florida and North Carolina, with burdensome prior-approval processes. To attract insurers—and thus give consumers more and better choices—states should establish clear, simple, market-based rate regulation processes and work towards eliminating rate regulation altogether.

But state governments should not shoulder all the blame. Even where opportunities exist, many insurers simply do not want to write more homeowners insurance policies. Although the industry itself is loath to admit it, homeowners insurance has almost never produced long-term underwriting profits. Thus insurers—even mutual enterprises that theoretically exist only for policyholder interest—do not write homeowners insurance as widely as they might. Even Illinois, which does not regulate homeowners insurance rates at all, saw seven insurers, all of them minor players, withdraw from its market in 2007. Creating a viable homeowners insurance market will require from the private sector innovation, financial fortitude, and a willingness to take risks.

States and private insurers, likewise, have failed to do enough to encourage homeowners to safeguard against natural disasters.

States and private insurers, likewise, have failed to do enough to encourage homeowners to safeguard against natural disasters. Only two states, Florida and South Carolina, have embarked on serious state-wide campaigns to promote mitigation efforts that make property more storm-resistant. The federal government ended nearly all ongoing federal mitigation programs after the Federal Emergency Management Agency (FEMA) was merged into the Department of Homeland Security.

Of course, risk-based insurance rates will do more to encourage mitigation by homeowners than government intervention can do. But the government does have a responsibility to reinforce public infrastructure and, insofar as it imposes building codes, should do so in ways that promote disaster-safe building practices.

8. Conclusion

On balance, 2008 saw an increasing government role in America's insurance markets. For every free-market reform, a regulatory setback increased government intervention in many states. State regulation, whatever its merits, has not succeeded in providing a forum for an insurance market that works well for Americans.

Our study reports the way things are, not the reasons they came into being. Differences in state insurance environments reflect geography, political personalities, means of insurance regulation, and citizens' preferences for one type of regulation rather than another, among other factors.

States need to reform their own laws, and the nation as a whole needs to consider efforts that would allow regulators to compete with one another. Optional federal charters, broader proposals for national insurance regulation, and laws allowing insurers to operate under one state law while doing business in another deserve consideration. For the moment, however, American consumers cannot always buy the insurance products they want, and companies cannot always sell them.