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focus REPORT

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Regulating homeowners insurance in Texas

With the continuing high cost of Texas homeowners insurance policies and the ongoing Sunset review of the Texas Department of Insurance (TDI), the Texas Legislature may consider changes to homeowners insurance regulation during the 2011 regular legislative session. The amount Texans pay for homeowners insurance is estimated to be between 52 and 76 percent more than the national average, depending on the type of policy forms being compared.

Before 2003, the last year in which the Legislature made comprehensive reforms to homeowners insurance regulation, premiums had increased nearly 45 percent in three years. The state faced a crisis of skyrocketing mold claims, and 99 percent of direct written premiums for homeowners insurance were issued by companies exempted from rate regulation. The 78th Legislature reviewed these and other issues and enacted a new regulatory system intended to limit the increase in homeowners rates by eliminating regulation exemptions and establishing a regulatory structure to promote rate competition.

Consumer advocates are calling for major changes to Texas' regulatory structure for homeowners insurance, saying that reforms in 2003 have not provided relief to homeowners paying excessive rates for insurance. They contend the current environment puts insurance industry interests ahead of consumer needs in the name of competition. Consumer advocates say that because standard insurance policy forms no longer are required statewide, insurers generally are offering less coverage but have not decreased premiums accordingly. They say many consumers are paying more for less coverage than before the 2003 revisions.

This report reviews the recent history of homeowners insurance regulation in Texas, as well as several proposals for change that the 82nd Legislature may confront during its 2011 regular session.

Insurers say that because Texas has some of the most extreme weather in the nation, the rates Texans pay for homeowners insurance are appropriate to address the risk. The direct losses and expenses paid by insurers in 2008, due mainly to hurricanes Ike and Dolly, exceeded direct premiums earned by more than $1.5 billion. The industry says profits in years with relatively low claims help pay claims when extreme weather strikes.

This report reviews the recent history of homeowners insurance regulation in Texas, as well as several proposals for change that the 82nd Legislature may confront during its 2011 regular session.

Sunset Commission recommendations

The Sunset Advisory Commission staff has conducted two recent reviews of TDI — a comprehensive review in 2008 and a limited, special-purpose review in 2010. Sunset staff evaluated TDI's implementation of the revisions to homeowners insurance regulation enacted in 2003 by SB 14 by Jackson. SB 14 made all homeowners insurers, including those whose rates previously had been unregulated, subject to a file-and-use rate regulation system. The Texas file-and-use system allows insurers to file a rate change, then put the new rate in effect immediately or whenever they choose. TDI may require prior approval of rates only if issues are identified with the insurer's financial condition or rating practices or in a statewide insurance emergency.

The Sunset Advisory Commission staff has conducted two recent reviews of TDI.

Sunset staff completed a comprehensive review of TDI before the 2009 regular legislative session. During this review, staff said that TDI's implementation of the file-and-use system lacked transparency and could cause unpredictability in regulation. The staff recommendations, which were adopted by the Sunset Advisory Commission, and the revisions proposed in SB 1007 by Hegar, the TDI Sunset bill in 2009, focused on clarifying the file-and-use process and the circumstances under which an insurer might be placed under the requirement for prior approval.

SB 1007 passed the Senate but died in the House after it was set on the Major State Calendar but no further action was taken. The 81st Legislature, in its first called session in 2009, enacted SB 2 by Hegar, which extended the Sunset date for TDI to September 1, 2011, but did not include any specific regulatory changes. SB 2 required the Sunset Advisory Commission staff to perform a limited special-purpose review of TDI in preparation for the regular session of the 82nd Legislature in 2011, rather than repeat the comprehensive review of 2008. Following the limited review of TDI, the Sunset Advisory Commission in July 2010 made substantively the same recommendations for homeowners insurance regulation that were made in the 2008 review.

Methods of rate regulation

Texas currently regulates homeowners insurance rates through a file-and-use system, in which insurers must file rate changes with TDI but are not required to wait for TDI approval to put new rates in effect. File-and-use is one of several rate regulation schemes common among the states. Prior approval systems require insurers to receive approval from regulators before they may change rates. Flexible rating systems allow insurers to implement new rates as long as the rates do not exceed or fall below an acceptable range set by regulators. The method by which homeowners insurance rates should be regulated in Texas has remained a source of debate since the regulatory process was changed to a file-and-use system in 2003.

Background

In 1991, to stabilize the insurance market and promote competition, the 72nd Legislature established a modified benchmark system that allowed for flexible rate-setting for homeowners insurance. Under this system, TDI annually established a benchmark rate for homeowners insurance. Insurers could charge any rate within a range of 30 percent more to 30 percent less than the state benchmark without prior approval from TDI, but had to receive prior approval from the insurance commissioner for rates set outside this "flexibility band."

The Legislature exempted homeowners policies provided by certain entities from the benchmark flexible rating system. These included Lloyd's plan insurers and reciprocal and interinsurance exchanges, which historically had written policies for only a small portion of the market and generally covered specialty risks at rates lower than the standard rates. Following this exemption, insurers began shifting more of their business to these non-rate-regulated entities. TDI estimated that by 2001, non-rate-regulated entities wrote about 95 percent of Texas homeowners insurance policies.

Homeowners insurance premiums increased significantly between 2000 and 2003, fueled by widespread, costly claims for mold damage and a market that largely was not subject to rate regulation. This prompted Gov. Rick Perry to declare the regulation of homeowners insurance an emergency issue for the 78th Legislature in 2003. Early in the 2003 regular session, the 78th Legislature enacted SB 310 by Fraser, requiring certain homeowners insurers to file current and projected rates and supporting data with the commissioner. TDI reported to the Legislature its findings about the rate filings required by SB 310 on March 28, 2003. The report indicated that in the previous three years, rates had increased statewide an average of 45 percent. Among the top 12 non-rate-regulated insurers, some rates were justified but others could be reduced as much as 25 percent, according to TDI.

The 78th Legislature later in the 2003 regular session enacted SB 14 by Jackson, which brought sweeping changes to homeowners insurance regulation. The bill made all homeowners insurers, including those whose rates previously were unregulated, subject to file-and-use rate regulation.

Under the Texas file-and-use system, insurers must file rates with TDI and may implement the rates immediately or whenever they choose. TDI may disapprove administratively a rate deemed excessive, inadequate, or unfairly discriminatory before the rate has been implemented or may disapprove a rate-in-effect through a contested case hearing at the State Office of Administrative Hearings. TDI may subject certain insurers to a prior approval process if the insurer’s financial condition or rating practices

Definitions

File-and-use — a regulatory structure under which insurers must file rates with state regulators but do not have to wait for approval before the rates may be used. Some states may require insurers to wait a specified number of days before a filed rate may be used. Regulators may retain the right to disapprove of a rate later if it violates the law.

Prior approval — a regulatory structure under which insurers must file rates with state regulators and then await approval of the rate prior to implementing it. Some states may deem a rate approved if the rate is not denied within a specified number of days.

Flex-rating — a regulatory structure under which prior approval of rates is not required unless rate changes exceed a certain percentage above, or in some cases below, previously filed rates. For slightly more than a decade starting in 1991, Texas used a variant of flex-rating in which the insurance commissioner set a benchmark rate and allowed insurers to use rates within a certain percentage of the benchmark rate without prior approval.

Policy form — documents that establish the types of losses an insurance policy will cover, the conditions under which these losses will be covered, and the dollar amount of that coverage.

Endorsement — modifications to a policy form that may clarify, broaden, or limit the scope of coverage.

Deductible — portion of a loss that the insured must pay before the insurance company pays the balance. This may be a flat fee or a percentage of the policy amount.

require supervision or if there is a statewide insurance emergency. Insurers subject to prior approval must file rates with TDI, then await approval before using the rates. If a rate is not approved or disapproved within 30 days, the insurer may deem the rate approved.

To establish a more appropriate baseline for rates in the new system, SB 14 also authorized TDI to require initial rate reductions for insurers found to be charging excessive rates. By September 2003, the insurance commissioner had ordered more than 30 companies to reduce rates by as much as 31 percent, for an overall reduction of 12 percent, amounting to a total of $510 million in rate reductions. All the insurers ultimately complied with the mandatory rate reductions except State Farm Lloyds, which was asked to reduce rates by 12 percent but refused. The stand-off between TDI and State Farm has played out since that time in the State Office of Administrative Hearings and in the courts. The matter is pending in Travis County district court. Because of State Farm's large market share, the rate reductions that were intended to save Texas consumers $510 million have saved them only $355 million.

Recent issues

In 2009, despite implementation of the file-and-use system, only 10 percent of homeowner insurers filed and began to use new rates on the same day. Many insurers have expressed concerns that the Texas system is more a "file-and-haggle" system than a file-and-use system. They say that because the rate-filing process is unpredictable, insurers face a risk that if they file and use a rate immediately, it later could be contested. They say this prevents them from using filed rates right away, which stifles the possible competitive benefits of the system.

SB 1007 by Hegar, the TDI Sunset bill introduced in the regular session in 2009, included provisions intended to make the rate filing process more predictable and to clarify what could subject an insurer to prior approval. SB 1007 would have required the commissioner to disapprove rates that did not comply with statutory requirements before a rate took effect or within 30 days of the day the rate was filed, whichever occurred first. If the commissioner had not disapproved a rate before these deadlines, the commissioner could have disapproved the rate only after a hearing. The bill would have required the commissioner to establish the financial conditions and rating practices that could subject an insurer to prior approval and to explain to insurers under prior approval the steps necessary to take to be excused from the order.

Those who support some form of file-and-use system say Texas has yet to see the rate reduction benefits that enhanced competition under such a system could provide because the current regulatory process contains too much uncertainty. They say the fear of TDI intervention increases costs throughout the industry because insurers must anticipate the risk of having a rate rejected and the administrative costs of haggling over the rate. This uncertainty also means that insurers rarely feel comfortable filing and immediately implementing rate changes.

Some file-and-use supporters say the Sunset recommendations would add the certainty that the current regulatory system is lacking, and others say TDI's authority to disapprove rates should be limited even more. Some would prefer that TDI be permitted only to disapprove rates-in-effect and would limit TDI regulation of "excessive" rates to circumstances in which the number of participating insurers was insufficient to maintain a competitive market. They say that in a competitive market, consumers will not pay excessive rates and the market will regulate itself naturally.

Those who oppose the file-and-use system say it has been harmful to consumers and that the Sunset review is an opportunity to change to a prior approval system — one that requires TDI to approve all rate changes before new rates may be used. Fifteen states were requiring prior approval of all homeowners insurance rate changes as of February 2010, according to information compiled by the National Association of Insurance Commissioners.

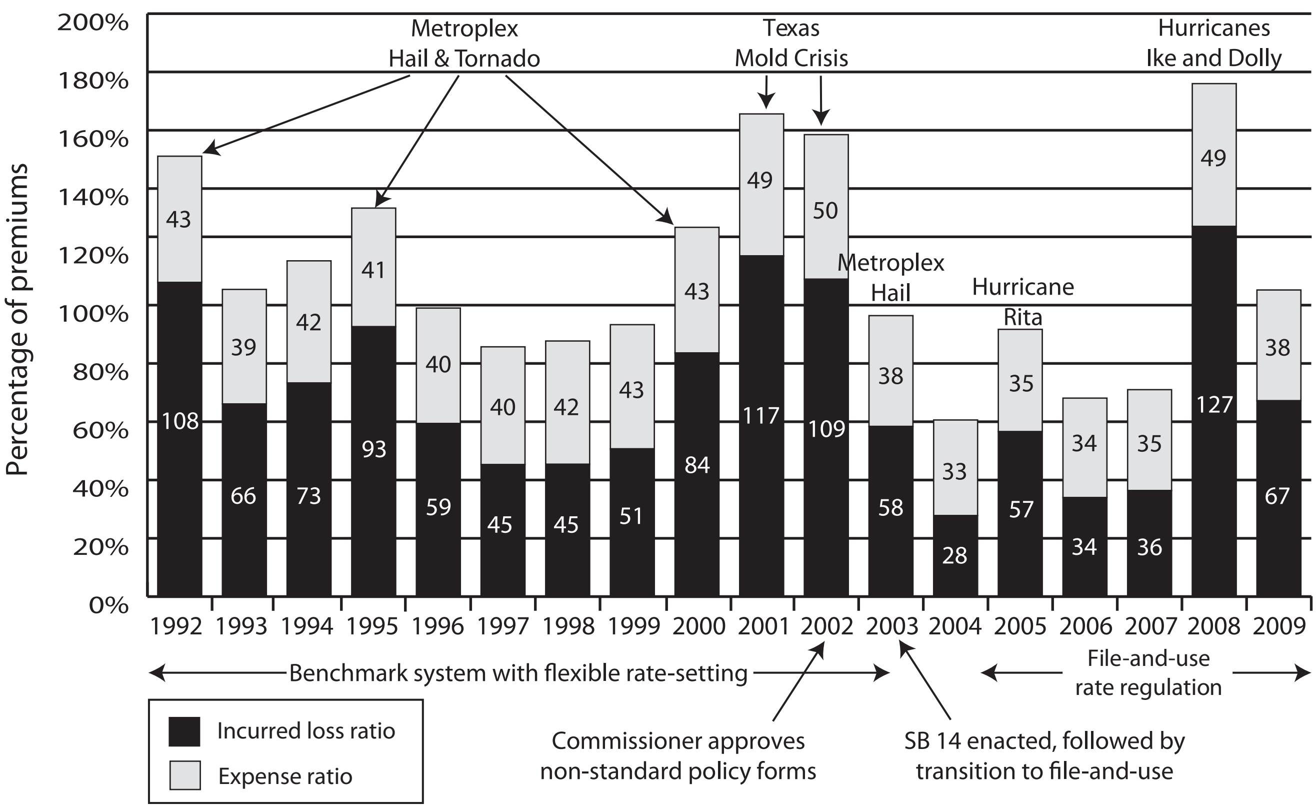
Debate about prior approval of rates

Supporters of implementing a prior approval system of rate regulation say that Texas homeowners deserve to have state regulators ensure that their insurance rates are not excessive or unfairly discriminatory before they have to pay them. The burden should rest squarely on insurers to justify why a rate increase is needed before consumers are asked to pay more for their insurance.

Consumer advocates say a file-and-use system benefits only insurers, making it more difficult to roll back inappropriate rate increases once they are in effect and therefore less likely that TDI will challenge a rate change that has been implemented. TDI currently cannot disapprove a rate in effect, even if the department deems it unfair or excessive, without an administrative hearing and possible appeal to a district court, which can be costly. Meanwhile, homeowners must pay the new, higher rates until the rate challenge is resolved. A prior approval system would prevent consumers from having to pay higher rates over many years while a rate dispute plays out in the courts. The unresolved dispute between State Farm Lloyds and TDI over a TDI request for State Farm Lloyds to reduce its rates has been in the courts since 2003, demonstrating insurer resolve to dispute the authority of TDI to regulate rates.

The file-and-use system was supposed to decrease Texas' insurance rates by enhancing competition, yet Texas consumers continue to pay some of the highest rates in the nation. As of 2007, the most recent year for which data are available, Texas homeowners insurance was the second most costly in the nation and was 76 percent more expensive than the national average for the most commonly purchased policy, according to the National Association of Insurance Commissioners. These high premiums have been assessed even as insurers have made huge profits in several recent years.

History of loss ratios for Texas homeowners insurance



***Incurred loss ratio** - annual losses incurred, including amounts already paid out plus the change in amounts set aside to cover future payments, as a proportion of the amount of premiums collected.*

***Expense ratio** - annual business expenses incurred as a proportion of the amount of premiums collected.*

***Combined loss ratio** - sum of incurred loss ratio and expense ratio.*

Source for loss ratio data: Texas Department of Insurance

Insurers' profits are demonstrated through their loss ratios. Loss ratios are a measure of an insurer's annual losses — amounts paid out plus the change in amounts set aside to cover future payments — as a proportion of the premiums an insurer collected that year. More specifically, the "combined loss ratio" is the amount of claims losses and business expenses incurred during a year as a percentage of the amount of premiums collected. Before 2008, when hurricanes Ike and Dolly struck, the average, combined loss ratio for insurers using rates under the new file-and-use system was 72.9 percent, meaning insurers were making profits averaging more than 27 percent from 2004 to 2007 *(see chart)*. This figure does not even include the additional profits insurers were making from investment income. While the year hurricanes Ike and Dolly struck was an extremely bad year for insurers, this level of loss is rare. Hurricane Ike was considered a 35- to 40-year storm, meaning that, on average, a storm of this size is expected to occur once every 35 to 40 years. Insurers will be pocketing huge, unjustified profits on the backs of consumers if they continue charging their current rates, say prior approval advocates.

Not only do Texas consumers pay more for their insurance than most of the country, but they pay more today for less coverage than they received before the shift to file-and-use. TDI's SB 310 report published in March 2003 estimated that after TDI began approving non-standard forms in 2002, the coverage Texas homeowners policies provided was reduced by between 15 and 45 percent, depending on the form. Despite the reduced coverage, as of March 2010, homeowners were paying on average about 5 percent more for their homeowners policies than in June 2003. This increase is especially troubling since the mold crisis and unregulated market already had caused homeowners insurance rates to spike 45 percent in the three years before the 2003 reforms, supporters of prior approval say.

A prior approval system would allow TDI to review and approve, and require insurers to justify, all rates before they were passed along to policyholders. This is necessary because the insurance market is not a standard competitive marketplace. Homeowners are required by mortgage lenders to have insurance and need it to protect their most valuable asset, their home. This necessitates rate review so that insurers do not take advantage of consumer vulnerability, prior approval advocates say.

Supporters of moving to a prior approval system say that a survey has demonstrated that prior approval is a system that people would want. Texas Watch, a consumer advocacy organization, had Hill Research Consultants conduct a poll in late August 2010 of 600 voters. Those surveyed were asked if they would approve or disapprove of the following proposal if it were presented to the Texas Legislature: ""PRIOR APPROVAL," which would require insurance companies submit and justify rate increases for review by the Texas Department of Insurance before they could go in to effect, not after." About 74 percent said they would approve, with 51 percent strongly approving. Only about 17 percent said they would disapprove, with 8 percent of those saying they would disapprove strongly.

Opponents of implementing a prior approval system of rate regulation say that prior approval systems inhibit the benefits of a competitive marketplace that can be tapped through file-and-use systems. A healthy, competitive insurance market with many participating insurers is the best way to ensure companies strive for efficiencies to keep costs down and to keep rates low enough to attract a large consumer base. File-and-use allows insurers to assess risks, file an actuarially justified rate, and immediately begin using the filed rate. By contrast, prior approval allows regulators to interfere with insurers' determinations of what rates are necessary to keep their business solvent in the long term.

The insurance industry is based on assessment of risk, and insurers must assess a variety of consumer, environmental, and regulatory factors, as well as the performance of the financial market, when setting rates. A prior approval system would introduce yet another risk to an insurer because the insurer would not know whether insurance regulators would approve rate changes. This could lead to worse outcomes for consumers because insurers would try to set higher rates to account for this higher risk and also could decide to leave the market or reduce the number of policies they wrote to avoid losses.

While efforts to increase regulation through proposals such as prior approval may be well intended, they lead to worse consumer outcomes. The biggest risk to consumers would be to regulate insurer rates in a way that led insurers to become insolvent and unable to pay consumer claims following a catastrophe because state regulators had prevented the insurer from establishing an adequate reserve. Although insurer profits were relatively high in 2006 and 2007, they allowed many insurers to stay in business despite the extreme losses they faced in 2008 for hurricanes Ike and Dolly.

The fact that only 10 percent of insurers feel confident enough to file and immediately use rates in the current file-and-use system means that Texas has yet to see the full advantages that a truly competitive file-and-use system could provide. Instead of racing to scrap the file-and-use system in favor of prior approval, Texas should implement the Sunset recommendations proposed last session to clarify the current file-and-use system for insurers. The state should consider still more reforms to optimize competition in the marketplace, such as allowing TDI to disapprove of rates only if they are discriminatory or inadequate and not if they are excessive, say prior approval opponents.

Prior approval advocates complain that rates are too high, yet since 2003 the industry has been hit by claims resulting from three major hurricanes. Insurers need to charge the rates they are charging in order to stay solvent and continue serving consumers in light of huge, weather-related losses. For example, the combined loss ratio in 2008 when Hurricanes Ike and Dolly hit was 176 percent. This means that the amount insurers needed to pay claims and business expenses that year was more than one-and-a-half times the amount of premiums collected. Surpluses in years with fewer claims are needed to pay for extreme losses such as these, critics of prior approval say.

Homeowners insurance policy forms

Policy forms establish the types of losses a policy will cover and the dollar amount of coverage. Endorsements are modifications to a policy form that may clarify, broaden, or limit the scope of coverage. For many years, Texas required all insurers to use the same policy forms and endorsements. The state has shifted away from requiring standard forms over the last decade, but not all parties have seen this as positive for consumers.

The state has shifted away from requiring standard forms over the last decade.

Background

In previous years, Texas homeowner insurers could offer only three standard, state-promulgated forms — the HO-A, HO-B, and HO-C. TDI also approved certain endorsements to these forms. More than 90 percent of homeowners had an HO-B policy, which covered all losses to a dwelling except those specifically excluded and covered the contents of a dwelling from losses due to specifically named perils.

In 1997, the 75th Legislature enacted SB 1499 by Sibley, which permitted TDI to approve policy forms and endorsements that were used by large, national insurers or that had been adopted by national insurance organizations. This marked the first occasion on which Texas authorized the use of forms other than the state's standard forms. Several insurers then filed alternate forms for approval, and in 2002 TDI approved the first alternate, national policy forms.

In response to rate spikes that followed a sudden increase in mold and water damage claims, TDI eliminated coverage for mold remediation in the standard HO-B form, effective January 1, 2002. At the same time, TDI established endorsements that gave policyholders the option to buy back mold and water remediation at various levels of coverage. Before this modification, some insurers had stopped writing or renewing Texas homeowners insurance policies because they said the lack of flexibility in forms prevented them from establishing specialized coverage for high-risk, costly situations like mold and water damage.

In 2003, the 78th Legislature enacted SB 14 by Jackson, which, among other changes, eliminated the requirement that insurers offer standard, state-promulgated homeowners insurance forms. While Texas no longer requires homeowners insurers to offer the state's standard forms, TDI must approve all alternate policy forms before they may be used. Many large insurers now use plans they use nationally that allow consumers to choose among many coverage options.

Recent issues

While supporters of the form deregulation enacted in 2003 cited the mold crisis as an example of why form deregulation was necessary, others believe form deregulation has been harmful to consumers and has made understanding the impact of the broader 2003 reforms more challenging. Several bills were filed during the 2009 legislative session that would have required homeowners insurers to offer standard forms while allowing them to continue offering their current forms.

SB 1, the general appropriations act for fiscal 2010-11, includes Art. 8, Department of Insurance, Rider 20, which directs TDI to conduct a review to determine what, if any, changes have occurred in the level of protection offered by homeowners insurance policies since the department's adoption of approved national forms in 2002.

Debate about using standard forms

Supporters of requiring insurers to file standard forms say that when all insurers are required to offer the same policy forms, consumers can make "apples to apples" comparisons of which companies offer the most affordable homeowners insurance coverage. Without such a tool, it is difficult if not impossible for consumers to interpret and compare complex policies to determine appropriate, cost-effective coverage.

Standard forms would not have to be required exclusively. Insurers could be allowed to continue offering their existing policy forms as well. Insurers also could make standard forms customizable with TDI-approved endorsements to meet a homeowner's specific needs.

The August 2010 Texas Watch poll shows that most voters like the idea of standard forms. The poll asked voters what they would think of the following proposal if presented to the Legislature: "Uniform standards, which would require insurance companies offer a few standard policies written in plain language that would be consistent across the industry." About 85 percent said they would approve, with 58 percent strongly approving. Only about 7 percent said they would disapprove or strongly disapprove.

Supporters of requiring insurers to offer standard policy forms say the need for standard forms is greater now than ever because insurers have been reducing coverage through crucial changes to policy wording. For example, the HO-B provides coverage for water damage for both "sudden and accidental" causes and for "continuous or repeated leakage." Many policies do not provide coverage for "continuous or repeated leakage," which a homeowner may discover only when a leak occurs and a claim is denied. Many insurance agents are not familiar with the small variances in wording between policies, so consumers should not be assumed to recognize these differences either.

While www.helpinsure.com is an excellent tool to perform basic policy comparisons, it is inadequate to help consumers understand the detailed differences in the content of various policy options that may make a large difference to their pocketbooks when filing a claim. Standard forms have been tested successfully in the marketplace and in the courts, providing the consistency that helps to preserve consumer protections. Even with plain language requirements, policy forms often are complicated and can be 50 or more pages long.

The industry exaggerates the costs of being required to offer standard forms because they fear that if consumers could compare directly the prices for the more comprehensive, standard forms they would realize how much insurers have been charging for much less comprehensive coverage. Another way the industry has used policy forms in recent years to boost profits is to significantly increase deductibles. Consumers formerly had more options to purchase policies with a flat deductible, such as $500. Increasingly, deductibles are a percentage of the policy amount. If a consumer with a 2 percent deductible made a claim on a home with $100,000 of coverage, that consumer would have to pay $2,000 instead of $500 before collecting on the policy. Some homeowners on the Texas coast have 5 percent wind deductibles, which are higher than the deductible charged by the Texas Windstorm Insurance Association, the state's insurer of last resort for coastal windstorm coverage.

Opponents of requiring insurers to file standard forms say that standard, Texas-specific forms would make homeowners coverage more costly without adding significant benefits. In other states, national companies may use their national forms exclusively. Having to maintain and market Texas-specific forms would lead to extra administrative expenses that are passed directly to Texas consumers in the form of higher homeowners insurance rates.

Texas consumers are no less savvy than consumers in other states who similarly must shop around for the most appropriate coverage, opponents of standard forms say. Texas consumers already have a tool that assists them in estimating the cost of homeowners coverage from various insurers. This tool is maintained by TDI at www.helpinsure.com. As in other states, if consumers have further questions about the amount of coverage a plan offers, they can use an insurance agent whose job it is to understand the differences between various policies.

Most Texas insurers use consumer credit information as a factor in establishing rates for homeowners insurance.

Opponents of standard forms say that even if insurers were allowed to continue offering their own forms in addition to the standard forms, they still would be subjected to major risks such as occurred during the mold crisis. For years prior to the surge in mold claims, insurers had anticipated potential problems with the state's standard forms and had been attempting to have TDI adopt changes to avoid these issues. TDI did not adopt any of these changes until 2002, after the industry already had lost billions. The fact that this environment put insurers at the mercy of state regulators caused several insurers to stop writing new policies in Texas until the forms were revised. The high mold claims costs directly led to dramatic rate increases for homeowners statewide, which could have been avoided had standard forms not been required.

Using credit scoring to set rates

Most Texas insurers use consumer credit information as a factor in establishing rates for homeowners insurance. They may consider individual components of credit reports, such as bankruptcies, or may compute credit scores based on numerous components of credit reports. Insurers calculate credit scores by placing various factors from a consumer's credit report into mathematical models that may vary from insurer to insurer. Homeowners insurers may use credit scores as a basis for providing discounts or imposing surcharges on certain consumers or for placing consumers in rating tiers.

Background

In the 1990s, insurers increasingly began using credit scoring as a component in setting consumers' homeowners insurance rates. This practice is permitted federally by the Federal Fair Credit Reporting Act (Public Law 91-508), which allows insurance companies to use consumer credit reports for underwriting purposes without notification or consent of the consumer.

Because most homeowners insurance policies were provided through non-rate-regulated companies in the early 2000s, it was not clear how most insurers were using credit scoring to determine consumer rates. TDI reported that complaints about credit-scoring practices increased from 40 in 2000 to more than 600 in 2002. SB 14 by Jackson, enacted in 2003, required companies to file with TDI their credit-scoring model along with other information to actuarially justify their rate filings. The bill also required TDI to conduct a study of how insurers were using credit information and how their credit scoring practices affected consumers.

In addition, under SB 14, an insurer may not deny, cancel, or non-renew a policy solely on the basis of credit information. Insurers must disclose to consumers if credit scoring will be used in underwriting. The insurance commissioner is required to establish rules limiting the allowable difference in rates charged by insurers due solely to differences in credit scores.

During TDI rulemaking, options were considered that would have limited to a fixed percentage of variance how much rates could vary on the basis of credit score. Ultimately, TDI ruled that any rate variance due solely to credit scoring would be acceptable if actuarially justified by data filed with the department.

Recent issues

Credit-scoring for insurance purposes has been an ongoing source of controversy due to concerns that it leads to discriminatory rating practices. Some states have banned the use of credit-scoring altogether. During the 81st Legislature, several bills were filed to ban the use of credit scoring in rate setting. An unsuccessful amendment also was offered during Senate consideration of SB 1007, the TDI Sunset bill, to ban credit scoring practices.

Debate about credit scoring in rate setting

Supporters of banning the use of credit scoring in policy rating say credit scoring is a discriminatory practice used as a proxy for setting rates based on race and is not an appropriate way to measure risk. Credit scoring often leads to rate increases for the consumers who can least afford them — even those who have never filed a claim. Many studies, including the December 2004 TDI study titled *Use of Credit Information by Insurers in Texas* and a 2007 Federal Trade Commission report, have found that credit-scoring scenarios disproportionately have a negative impact on African Americans, Latinos, and people with lower incomes. Supporters of banning the use of credit scoring say its use in rate setting is not justified. For example, a low credit score does not increase the risk that a hailstorm will strike a person's home, resulting in a claim.

Opponents of banning the use of credit-scoring in policy rating say credit-scoring has proved an accurate way to measure risk and is not intentionally discriminatory. A supplemental analysis to TDI's December 2004 report found that the 10 percent of policyholders with the worst credit scores were 1.5 to 2 times more likely to file a claim than the 10 percent of policyholders with the best credit scores. The 2007 Federal Trade Commission study corroborated that lower credit scores predict a higher number of insurance claims. Whatever the factor that drives the risk association between credit scores and claims frequency, insurers should be able to measure this actuarially

Should the commissioner of insurance be elected or appointed?

In Texas, the commissioner of insurance directs the policy and operations of the Department of Insurance. The governor, with the Senate's confirmation, appoints the commissioner of insurance for a two-year term. Eleven states elect their insurance commissioners. Several of these states restrict or ban contributions from insurance companies to commissioner candidates, citing conflict-of-interest concerns about regulators accepting donations from the industry they regulate. During the 2009 regular session of the 81st Texas Legislature, several bills and an amendment offered to the TDI Sunset bill in the Senate would have made the commissioner of insurance an elected position in Texas. None of these proposals was enacted.

Supporters of making the commissioner of insurance an elected office say that an elected commissioner would be more responsive to consumers than an appointed commissioner. For homeowners insurance regulation, they say, an elected commissioner would enhance consumer protection in oversight of rate-setting and form regulation. Texans elect their agriculture and railroad commissioners, who have less impact on the lives of Texans than the insurance commissioner, supporters of electing the insurance commissioner say. They say the commissioner directs policy that influences all Texas homeowners and other consumers yet is accountable only to the governor.

Opponents of making the commissioner of insurance an elected office say the insurance commissioner should be an impartial regulator, not an elected official. They say the best way for an insurance commissioner candidate to appeal to citizens would be to run on the premise of lowering insurance rates, yet the market does not always safely allow this goal. Opponents express concern that an insurance commissioner elected with the mandate to lower rates could implement policies that could jeopardize insurer solvency.

supported indicator of risk and charge rates accordingly. If credit scoring were suddenly banned, the insurance market would be disrupted and many consumers with good credit scores would experience a sudden increase in their premiums.

Expediting appeals in contested rate cases

Insurers may appeal homeowners insurance rate filings that have been disapproved by TDI. The rate dispute between TDI and State Farm Lloyds that has persisted since 2003 has highlighted for many observers the need to refine the process for appealing rate cases for homeowners insurance so rate appeals may be resolved more quickly. The House Committee on Insurance is required by an interim charge to the 81st Legislature to "study whether a new system or process should be employed to expedite appeals by insurers against TDI in homeowner's rate cases."

Background

Currently, the insurance commissioner may disapprove administratively a filed rate before it is implemented or may refer, with proper notice, a rate-in-effect for a hearing before the State Office of Administrative Hearings (SOAH). SOAH issues a proposed decision in contested rate cases, and the commissioner reviews this decision to make a final determination about whether to disapprove a rate. The law does not establish clear timeframes for how quickly a SOAH hearing must be conducted nor how long the commissioner has to issue a final order. An insurer may appeal a disapproved rate to the Travis County district court. Further appeals advance to the Third Court of Appeals in Austin and the Texas Supreme Court.

Recent issues

In September 2003, following enactment that year of major insurance reforms during the regular legislative session, TDI reviewed homeowners rates and ordered more than 30 insurers to reduce rates found to be excessive. State Farm Lloyds was ordered to reduce rates by 12 percent but refused. The company appealed the commissioner's order to the Travis County district court. Since that appeal, TDI and State Farm Lloyds have faced off in SOAH, district court, and the Third Court of Appeals, without resolution.

In May 2008, the Third Court of Appeals ordered TDI to rehear the case. Based on that rehearing, the commissioner found State Farm Lloyds' rates from 2003 to 2008 to be excessive and in November 2009 ordered the company to pay more than $310 million in refunds and interest to consumers. State Farm Lloyds appealed the order to the Travis County district court, where the case remains pending.

Consumer advocates are frustrated that the $310 million they feel consumers are owed still cannot be refunded after seven years of legal battles. They feel the best solution would be to avoid having consumer funds tied up during legal battles by requiring the commissioner's prior approval of all rate changes. Short of this proposal, many feel there are ways to improve the current system that could speed the rate appeals process.

Proposals for expediting appeals

Various proposals to speed up the appeals process have emerged for potential consideration by the 82nd Legislature. Lawmakers could consider amending the administrative and judicial processes in contested rate cases to expedite appeals. The Legislature could establish timeframes in which SOAH hearings would have to occur and limit how long the commissioner had to issue an order based upon the SOAH decision. The scope and timeline for the SOAH discovery process also could be limited. In the courts, the Travis County district court could be bypassed and rate appeals instead could be sent directly to appeals courts. A special court could be established within the Austin Court of Appeals to perform expedited reviews of rate appeals. Finally, the state could implement an arbitration system for appeals. Florida had an arbitration process from 1996 until 2007 that gave a three-member arbitration panel 90 days to issue a decision about a rate appeal.

While parties on all sides of rate disputes claim they could benefit from expediting the appeals process, they say that proposals for change should be scrutinized to ensure they do not infringe on any party's due process rights. They say that any proposal to expedite contested rate cases should maintain the basic rights outlined for contested cases in the Texas Administrative Procedure Act (Government Code, ch. 2001) — including the right to a hearing and to conduct discovery, present witness testimony, cross-examine witnesses, and appeal.

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