Written Testimony of Eli Lehrer
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Before the Texas Senate Committee on Business and Commerce
July 10, 2012

Members of the Committee:

I thank you for taking the time to address this important topic and for your concern for creating a better insurance environment for the people of Texas.

I come today as a representative of R Street Institute, a new think tank co-founded by former staffers of the Heartland Institute. R Street, which takes its name from the street dividing Washington, D.C.'s government and lobbying districts from its ordinary neighborhoods, is a think tank dedicated to free markets; limited, effective government; and responsible environmental stewardship. Here in Texas, we are ably represented by our state director, Julie Howard Drenner.

I will focus my testimony on one of your questions, although I am delighted to entertain questions on the others. In particular, I'd like to take up your charge to "Compare Texas' homeowners insurance premiums with those of other states and identify the factors underlying Texas' premium levels and recommend steps that the Legislature may take to reduce homeowners rates, if appropriate."

On this topic, I have three major comments:

- *Texas' homeowners insurance premiums rank among the highest in the country but are not* the *highest.*
- *The primary factors determining insurance premiums in the state relate to natural risks and are beyond the Legislature's control.*
- *Policies that provide greater regulatory and legal certainty, enhance building codes, and allow for greater competition in the reinsurance market have the greatest prospects for moderating rate increases in the future.*

My more detailed comments follow.

Texas' homeowners insurance premiums rank among the highest in the country but are not* the *highest.

The National Association of Insurance Commissioners finds that Texas' homeowners insurance rates have ranked as either the highest or the second highest in the country for most of the past decade.[1] There is little doubt Texas homeowners do pay more than residents of most states, and a fair part of this difference stems from high potential hurricane losses in roughly 20 counties, as well as high hail losses inland.

However, the rates are not universal. Residents of Texas' three cities with more than 1 million residents, for example, pay rates actually a bit lower than those in other big cities. Furthermore, consumers in at least one other state, Florida, do actually have higher costs than those in Texas. Three data points explain this.

First, the NAIC's rate comparisons do not include taxes called "special assessments" added to insurance policies and paid by consumers. In Florida, these assessments primarily pay claims owed by the state's residual market property insurer, Citizens Property Insurance Corp., and finance bonds floated by the state-run reinsurer, the Florida Hurricane Catastrophe Fund. In 2010, the most recent year for which we have comparable data for all states, Florida residents paid assessments totaling 8.4 percent on all homeowners insurance policies and an additional 1 percent on most other personal lines of insurance, such as auto insurance.[2] That exceeds the 5 percent difference in costs reported in the NAIC's raw data.

Second, special assessments following a storm, in a worst-case scenario, could add more than $1,000 to a typical Florida homeowner's insurance bill.[3] Insurance premiums do not reflect these costs upfront, but consumers would, nonetheless, have to pay them eventually. Although the risk of assessments from residual markets and/or insurance guaranty funds exists in all states, including Texas, the magnitude differs greatly, and Florida's "pay later" costs could be quite significant for a typical homeowner.

Third, the NAIC data reflect only premiums paid for complete homeowners insurance coverage. In states offering partial coverage through a public entity—including "wind/hail only" policies offered in most hurricane prone states and earthquake coverage through California's state-run entity—the apparent premiums

[1] See e.g. Insurance Information Institute*. Insurance Fact Book 2012,* 97*. http://www.iii.org/factbook/.*

[2] Florida Citizens Property Insurance Corporation. "Assessments," https://www.citizensfla.com/about/CitizensAssessments.cfm

[3] Stephen Alexander. "Potential Assessments from Florida Hurricanes," Office of the Insurance Consumer Advocate, State of Florida, http://www.myfloridacfo.com/ica/docs/AssessmentStudy.pdf

are lower. Although this impacts almost all states, including Texas, the number of such "wind only" policies is the greatest in Florida.

Florida's current system for property insurance has not made things affordable and any reduction in premiums has been at the cost of the impairment of insurer solvency. While Texans do pay a lot for insurance, Floridians have it worse. Nationally recognized (and well-capitalized) insurance companies have largely fled the state, forcing almost 1.5 million homeowners into Florida's state-run insurance company. Florida, therefore, should not be viewed as a model for cost control.

The primary factors determining insurance premiums in the state relate to natural risks and are beyond the Legislature's control.

Property insurance is expensive in Texas because Texas is a risky place to live. The state has the third-longest and second most-populated Gulf Coast coastline[4], has experienced the second-most hurricanes of any state[5], has had the most tornadoes of any state[6], the most tornado deaths of any state, and the most thunderstorm and hail damage of any state.[7] It is also the site of the deadliest storm in United States history, the 1900 Galveston Hurricane. Unlike other hurricane-prone states, which have relatively warm weather and little snowfall, Texas gets plenty of snow. The state also has had well-known problems with mold. And the state sees natural disasters most people don't even know about. For example it's one of few states with a risk of giant, potentially destructive dust storms called Haboobs.[8]

Because all of these things have happened in Texas in the past, scientists who study these phenomena assign a risk they could happen in the future. Insurance rates must take all of these risks into account. Because it is a relatively dangerous place to live, insurance premiums in Texas will never be low. Quite simply, no practical public policy course the Legislature could pursue is likely to stop any of these disasters from happening. When losses are high, premiums are high. However, public policy can make a real and meaningful difference for Texas residents.

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[4] Bureau of the Census. Table 364. "Coastline and Shoreline of the United States by State," http://www.census.gov/compendia/statab/2012/tables/12s0364.pdf

[5] E.S. Blake et al. "NOAA Technical Memorandum NWS NHC-6 The Deadliest, Costliest and Most Intense United States Tropical Cyclones from 1851 to 2010," National Hurricane Center, 2011, http://www.nhc.noaa.gov/pdf/nws-nhc-6.pdf

[6] National Weather Service. "Tornado Numbers, Deaths, Injuries and Adjusted Damage," http://www.erh.noaa.gov/cae/svrwx/tornadobystate.htm

[7] Ibid.

[8] National Weather Service. "Intense Cold Front Produces Severe Winds and Blowing Dust, 17 October 2011" http://www.srh.noaa.gov/lub/?n=events-2011-20111017-haboob

Policies that provide greater regulatory and legal certainty, enhance building codes, and allow for greater competition in the reinsurance market have the greatest prospects for moderating rate increases in the future.

While premiums in Texas will be high under any circumstances, there are steps the Legislature can take that could impact rates. Three particular actions stand out in this regard.

- *Texas must make its insurance regulatory system and legal systems clearer and more attractive to capital.*

The 2012 Insurance Regulation Report card produced by my organization, R Street, and previously produced by the Heartland Institute, since its inception, has ranked Texas near the very bottom of all states. The report card's most recent edition, issued last month and edited by my colleague R.J. Lehmann, shows similarly bad results for Texas. The state gets a letter grade of "D" and has the third-lowest aggregate score of any state.[9] While different states are downgraded for different reasons, Texas' grade is low largely because its regulatory system is so confused.

First, the Texas Department of Insurance, under a previous commissioner, has maintained "desk drawer rules." While the insurance statutes on the books describe a "file and use" rate regulation system essentially similar to that used in many other states, the actual experience of insurers with TDI is far different. In practice, under a previous commissioner, department staff would often tell insurers rates would be disapproved if they were filed and, thereby, subverted the plain language of the statute. Second, Texas, as our report card shows, accumulates a large "regulatory surplus" because it uses money derived from premium taxes for things other than insurance regulation. This places a disproportionate burden on insurance consumers for funding state government and makes insurance relatively less attractive to purchase on the margin.

The rules governing TWIA and the state's legal environment add an additional source of uncertainty. Currently, all insurers in the state are subject to special assessments from TWIA.[10] Although these assessments are not nearly as large as those possible in Florida, they still represent a risk that all private carriers in the state must incorporate into pricing in much the same manner in which they incorporate the risk of storms themselves.

Legal risks add to this uncertainty. Media reports indicate that a single law firm collected more than $86 million in fees as part of a $189 million settlement with

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[9] R.J. Lehmann. "2012 Insurance Regulation Report Card," R Street, June 2012, http://rstreet.org/policy-studies/

[10] See e.g. TWIA. "GAAP Financial Statements 2007-2008," 13. "Members are assessed to the extent that the Association's Board of Directors determines that available funds are not sufficient to meet the obligations of the Association."

TWIA—about 45 cents on the dollar collected.[11] The sheer size of these fees also adds a cost load and produces additional uncertainty about the soundness of the state's legal system for companies considering decisions to invest in the state. If they make mistakes—as many insurers will—the courts will not only make them pay for these mistakes (as they should) but also award ungodly sums to plaintiffs' attorneys.

While the actions of the current insurance commissioner and TWIA's recent moves to reinsure some of its risk (thus reducing assessment risk) have mitigated a few of these risks, all of them still exist. In other words, while Texas takes pride in being a business-friendly state, the legal and regulatory environments are, if anything, hostile to insurers and insurance capital.

This, in turn, has led to an environment where homeowners insurers are reluctant to enter the state. While Texas is the physically largest and most geographically diverse of the lower 48 states, its homeowners insurance market is surprisingly concentrated given its size. States like Vermont, Iowa, Georgia, and Connecticut—all of which are much smaller—actually have more carriers willing to write homeowners insurance. The largest companies are active in all of these states, but, in one way or another, small and regional carriers have found themselves unable to do business in Texas. A system allowing free markets, rather than government bureaucrats, to set Texas' insurance rates would likely serve consumers the best and result in the lowest overall insurance rates. Even if Texas is unwilling to do away with rate regulation altogether, however, it should at least aim for certainty in the way it regulates insurance and the legal environment in which insurers operate.

- *Texas should look into ways to encourage stronger building that is more resistant to nature's worst.*

Texas' built environment is not nearly resistant enough to storms and other natural disasters, and the Legislature should consider implementing stronger building standards. The Institute for Building and Home Safety each year ranks all hurricane-prone states on their building code policies. Texas comes third from the bottom, far below other similarly threatened states like Louisiana and Florida.[12] Although I do not agree with all of IBHS's recommendations, particularly with regard to the desirability of more stringent contractor licensing, the current situation shows a lack of attention to issues of building safety in the state. The state's enormous geographic diversity, indeed, may make it impractical to impose new codes on a statewide basis, but, at minimum, the state should do more to assure that inspectors themselves are well-qualified and to incentivize localities to adopt appropriate

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[11] Elise Hu. "Taylor Can't Believe 'Firestorm over TWIA Request." Texas Tribune. September 10, 2010, http://www.texastribune.org/texas-special-interest-groups/texas-windstorm-insurance-association/taylor-cant-believe-firestorm-over-twia-request/

[12] Institute for Building and Home Safety. "Rating the States: Atlantic and Gulf Coast States, 2012," http://disastersafety.org/hurricane/rating-the-states_ibhs/

building codes. The right policies can have an enormous impact. One IBHS study about mitigation against hailstorms in Texas comes to a conclusion that's worth repeating:

> Homes with roof coverings classified as impact resistant were 40 percent less likely to have claims – and even less likely to have claims resulting in insurance payments – than those without. The claims rate for policies on homes with impact-resistant roofs was actually 55 percent lower than for policies on homes without impact-resistant roofs.[13]

The conclusion here is simple: mitigation works for hail and it can work in other cases as well.

The state should also work to enhance and augment its current policies—and support federal policies such as the Coastal Barrier Resources Act—that withdraw subsidies from development in disaster-prone areas. Between 1960 and 2008, Texas' coastal counties added 3.6 million residents, the third-largest increase in the nation, and its coastal population grew by 155 percent, the fourth largest percentage change.[14] Between 2000 and 2030, the U.S. Census Bureau projects Texas coastal counties to add 12.5 million more residents, second only to Florida's projected coastal growth of 12.7 million residents.[15]

I believe landowners ought to have exceptionally broad rights to develop their property in whatever manner they see fit. But that is very different from saying they are entitled to government funds to help them fill in wetlands, build out storm-prone beaches, and endanger wildlife habitat, much less receive subsidized rates for their insurance. Current policy, both federally and at the state level, encourages these actions. The State of Texas probably will not and should not impose laws that unduly interfere with the use of private property. But it can help to educate localities about the risks they face and end all policies that provide perverse incentives.

- *Texas should adopt nationally recognized standards for reinsurance capital in order to improve competition in the insurance and reinsurance market.*

In catastrophe-prone states like Texas, insurance for insurance companies—reinsurance—plays a key role in the overall risk management marketplace. Reinsurance allows insurers, even small ones, to manage their risks across a global

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13 Institute for Building and Home Safety. "IBHS Insurance Claim Hail Study: Investigation into Insured Losses and Damages to Single-Family Homes Resulting from the April 5, 2003 North Texas Hailstorms," http://disastersafety.org/wp-content/uploads/Hail_Texas_ES.pdf

14 U.S. Census Bureau, Decennial Census of Population and Housing: 1960 to 2000; Population Estimates Program: 2008.

15 Ibid.

pool. By purchasing reinsurance, an insurer can pool the risk of hailstorms in Texas with that of earthquakes in Japan, floods in the United Kingdom, and industrial accidents in Germany. This broader risk-spreading, all other things being equal, reduces the cost of insurance for consumers and increases competition by giving insurers access to larger pools of capital. And global reinsurers would love to do more business here in Texas.

But Texas makes the purchase of global reinsurance unattractive. Unlike New York, Florida, New Jersey, and Indiana, Texas still has not adopted the NAIC's modernized standards for reinsurance collateral. These changes make it easier for insurers operating in a state to make use of capital from around the world by reducing the collateral requirements imposed on offshore reinsurers from competently regulated jurisdictions.[16] There is, so far as I know, no opposition to these standards from any major insurance industry trade association, any consumer group, or any of the carriers with a significant homeowners insurance market share in Texas. They are simply common sense and they have real potential to reduce the costs of insurance in Texas. The Legislature should work to adopt them posthaste.

Conclusions

Insurance in Texas is expensive, although not as expensive as insurance in Florida. The high costs of insurance in Texas are driven mostly by natural factors that realistic public policies cannot hope to impact in the short or medium terms.

In solving its problems, Texas must rely on its own laws and resources. Nearly all federal proposals that would make changes to the insurance market would raise rates for Texas residents.

And Texas can address its problems. If the state wants to build a better, more affordable insurance system for its residents, it should work to improve legal and regulatory certainty, strengthen building standards, and adopt modern reinsurance collateral requirements. None of these things will ever make insurance cheap. But all of them, together, can make insurance more affordable to the state's consumers.

Respectfully Submitted,

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[16] For an outline of the proposals see: National Association of Insurance Commissioners. "NAIC Adopts Revisions to Reinsurance Models," http://www.naic.org/Releases/2011_docs/naic_adopts_revisions_to_reinsurance_models.htm

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