# The Regulatory Death Spiral: Why Price Regulation of Homeowners Insurance Means Consumers Pay More

***The Case of Florida Homeowners Insurance Regulations***

Stephen B. Pociask

February 9, 2011

# The Regulatory Death Spiral: Why Price Regulation of Homeowners Insurance Means Consumers Pay More

## *The Case of Florida Homeowner Insurance Regulation*

Stephen B. Pociask

February 9, 2011

The American Consumer Institute
Center for Citizen Research

# The Regulatory Death Spiral: Why Price Regulation of Homeowners Insurance Means Consumers Pay More

Stephen B. Pociask

## Executive Summary

This study analyzes the economic literature and empirical evidence on the effectiveness of price regulation of homeowners insurance. Evidence presented in this study demonstrates that price regulation has been a dismal failure for consumers, because it creates a dysfunctional market that (longer term) produces higher costs and worse outcomes for consumers, compared to markets without price regulation. This study finds that states with stringent state price regulations, like in Florida and increasingly in Texas, can set in motion a course of events that produce adverse consequences for consumers by transforming a functioning market into a high-cost, less solvent market – a process referred to in this study as *the regulatory death spiral*.

This regulatory death spiral begins when state regulators try to hold insurance prices below their natural market equilibrium level, which creates market shortages and drives insurers, particularly large multi-state insurers, out of the state market. When this happens, it decreases the capital funds that insurers reserve to pay for consumer claims, referred to here as *policyholder surplus*. Because insurers that cutback their operations tend to be among the largest and most capitalized insurers, they generally leave behind smaller and weaker insurers to operate in the state. These remaining firms, however, are under even more pressure to increase prices in order to increase policyholder surplus. If regulators continue to hold the line on prices, they continue to premium-starve these remaining firms, thereby risking insolvency in the event of major losses from a storm. It's a death of the industry and harmful to consumers who need affordable insurance. In

---

Steve Pociask is president of the American Consumer Institute Center for Citizen Research (ACI), a nonprofit research and education organization. The author wishes to recognize and thank Professor Joseph P. Fuhr, Jr. for his insightful comments to this study. For more information about the Institute, visit www.theamericanconsumer.org.

effect, the attempt by state regulators to reduce prices has the exact opposite effect – it ultimately raises industry costs and requires higher consumer prices to support the reduction in policyholder surplus. This has been shown to occur in heavily regulated markets and is exactly what has happened in Florida – where lower surplus is leading to less protection for consumers, a dysfunctional market, a lack of price competition, and the highest prices in the nation. Now, Floridians are stuck – not because of market failures but because of public policy failures.

In Florida, and states considering similar public policies, the best solution for policymakers is to avoid this regulatory death spiral by staying away from price regulation, instead protecting consumers with solvency regulation and encouraging price competition. In turn, this will attract market participation and capital back to the state, thereby lowering prices for consumers without sacrificing solvency. In Florida, this can be accomplished by downsizing and requiring financially sound rates for Citizens and the state catastrophe fund, permitting price flexibility, and reducing insurance costs caused fraud, outdated bad faith laws and a public adjuster process in need of reform. These steps will reduce industry costs, attract private capital, lead to increased solvency and encourage price competition – all for the betterment of homeowners.

While policymakers may believe they can set prices, the reality is that they are putting consumers and their property at risk – perhaps all for short political gain. Ironically, the regulators whose pricing policies are working to destroy an efficient market will be the same ones left to run it. Until reforms take place, consumers will be paying more for less.

# The Regulatory Death Spiral: Why Price Regulation of Homeowners Insurance Means Consumers Pay More

## Introduction

Price regulation of property and casualty insurance in America has been a failure. As standard microeconomic textbooks on supply and demand explain, when regulators mandate artificially lower homeowner insurance prices in a state, the market is put into disequilibrium, which creates shortages.[1] Unable to raise prices in line with expected losses, some insurers stop writing policies, others pull out of risky areas (such as coastal areas) and still others leave the state all together. Those that leave tend to be larger and healthier multi-state providers that can operate in other states. Such firms usually hold the majority of surplus funds needed for major storm claims. As these firms exit the market, total industry surplus decreases, reducing reserves intended to protect consumers. What remains are somewhat smaller insurers and those that only operate primarily in that one state – they simply have nowhere else to go. Because smaller insurers spread risk over a smaller customer base, they are more exposed to risk. These smaller insurers are also often less geographically diversified, again making them a higher risk. These added risks raise industry costs and they put upward pressure on the remaining smaller companies to build up policyholder surplus in order to protect consumers against catastrophic losses. However, building up the shortfall in policyholder surplus requires higher premiums. Because state insurance regulators mandate artificially lower premiums, smaller firms are unable to increase surplus, leaving them and the general market on weaker financial footing. In other words, by regulating price, state regulators have altered the mix of firms that serve these markets, increasing risks and costs. This is exactly the opposite effect of what policymakers intended.

[1] See F. W. Taussig, *Principles of Economics*, Volume I, The MacMillan Company, New York, 1915, p. 145, stating "As prices go lower, supply will become smaller." Also see C. E. Ferguson and J. P. Gould, *Microeconomic Theory*, Richard D. Irwin, Homewood, IL, 1975. When regulators set price ceilings, shortages are created and regulators have trouble finding "the right price" (p. 305, fn 17). They also provide evidence of deregulation ending such shortages (p. 255).

As a result, the attempt by regulators to reduce market price has had the unintended consequence of putting more pressure on prices. Now, regulators have given themselves few options for going forward. If regulators attempt to hold the line on prices, more insurers leave, and they premium-starve the remaining (more costly and more risky) firms, thereby further reducing policyholder surplus from cash-strapped insurers and further risking insolvency in the event of major storm losses. As insurers leave the market, more shortages are created and consumers are left looking for protection. In effect, the industry has been put into something like a regulatory death spiral, where competition is replaced by social pricing, the market becomes dependent on state catastrophe and reinsurance funds, and consumers are left to pay more for less.

This is the "price of price regulation" – with lower surplus levels to protect consumers against major losses, and with a dysfunctional, higher cost market. Now there is a dilemma – continuing regulation will continue to destroy the market, but deregulating prices will likely increase prices in the short run, because the market is now dominated by a mix of higher risk and higher cost insurers. So consumers are stuck. This scenario is not hypothetical. It is similar to what has happened in Florida and what already appears to be occurring in other states, like Texas.[2]

## Why Regulate Prices?

Property insurance is subject to varying degrees of state price regulations. A few states actively set or approve prices, a few state do not regulate prices at all, and many states are somewhere in between. The differences among the states provide an opportunity to test whether or not price regulation benefits consumers. The section to follow reviews the empirical evidence.

Economic theory suggests that intervention in the market could be justified if there is a clear market failure, and if the remedy for correcting this market failure provides more benefit than cost. This means that there needs to be an identified problem

[2] Stephen B. Pociask, "Will Texans Pay More for Less? How Insurance Price Regulation Poses Adverse Consequences on Texas Consumers," ConsumerGram, The American Consumer Institute, Forthcoming.

worth fixing (a problem that harms social welfare), and any solution should not swap market failures for government failures. After all, government policies fail too and, because government failures do not self-correct, the end result could be far worse (longer term) than market failures.

It is not clear exactly how price regulation improves the way insurance markets functions. For one, monitoring insurance industry solvency does not warrant lowering prices, since that would have the opposite effect. In fact, insurance regulation first began to ensure that premiums were *high* enough to guarantee the payment of consumer claims. In other words, protecting consumers against fraud is not a problem solved by controlling prices. Furthermore, when regulators set market prices, they replace price competition for collusion, which can affect service quality and innovation, as well as market participation. It is not clear how consumers benefit from any of these outcomes, nor is it clear how diverging from market prices would increase social welfare.

So what then are the reasons for rate regulation? While the economic reasons for price regulation have not been well articulated by those doing it, the reasons seem to center around two major themes: 1) the industry is concentrated (or not competitive); and 2) the industry is price-gouging consumer (or overly profitable). Are these populous sounding themes supported by empirical evidence?

Starting with the theme that the insurance industry is heavily concentrated and there is a lack of competition, there are thousands of insurance companies (across all lines) in the U.S. and most states have over one hundred homeowner insurers, making this industry more competitive than many other industries.[3] Furthermore, the use of market structure as a proxy for competition has been long dismissed in the economic

[3] Stephen B. Pociask, Joseph P. Fuhr and Larry F. Darby, "Insurance Regulation: Market or Government Failure?" The American Consumer Institute, March 20, 2007, p. 18; Stephen B. Pociask, "Does State Private Passenger Automobile Price Regulation Benefit Consumers? The Myths and Facts," The American Consumer Institute, February 12, 2009, p. 6; and Joseph P. Fuhr, Jr. and Steve Pociask, "Private Passenger Automobile Insurance Regulation: An Analysis of Industry Structure, Conduct and Performance," The American Consumer Institute, DRAFT, October 29, 2009, pp. 7-9.

literature.[4] If regulators wanted more competitors, *not* regulating price would increase, not decrease, market participation. Furthermore, the nature of state-level regulation prohibits interstate competition. So, while there appears to be plenty of competitors in the market, the primary, if not the only, threat to competition and market participation results from regulation itself.

There is also no empirical support for the second theme – that insurers set prices too high or are too profitable. Because there are adequate participants in the market, if any firm tried to set prices too high, consumers could switch to lower-priced competitors. So price gougers are disciplined by the market forces, and firms that price more efficiently are rewarded. Putting these theoretical arguments aside, evidence shows that the insurance industry is earning relatively low profits, compared to the S&P 500 (see **Chart 1** below). This suggests there is no market power, as defined by the Lerner Index.[5]

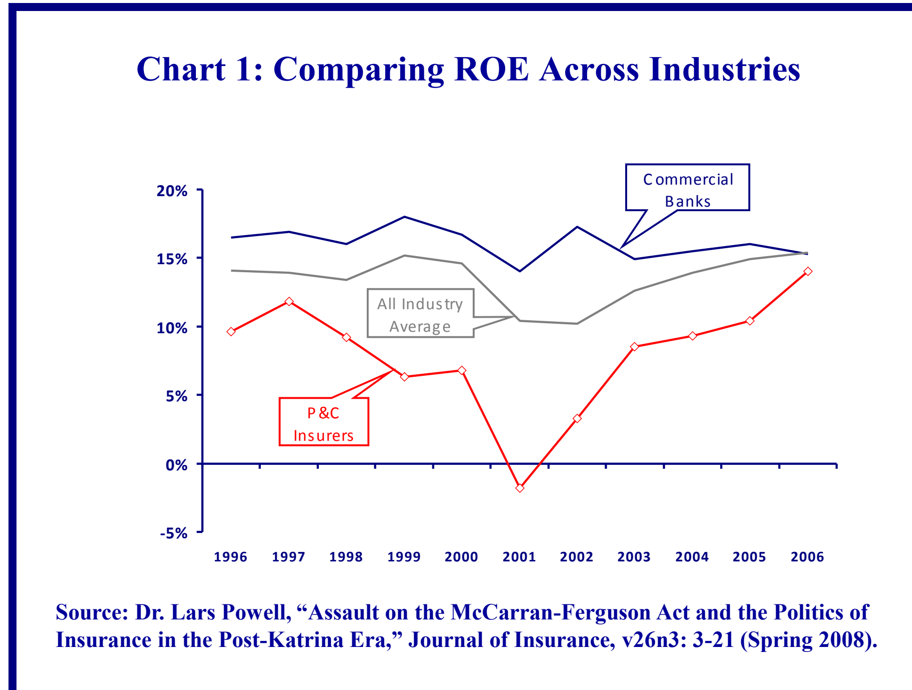



**Chart 1: Comparing ROE Across Industries**

**Source: Dr. Lars Powell, "Assault on the McCarran-Ferguson Act and the Politics of Insurance in the Post-Katrina Era," Journal of Insurance, v26n3: 3-21 (Spring 2008).**

---

[4] Structure, conduct and performance paradigm has been turned on its head – industry concentration is not a problem and, in the case of economies of scale and scope, a small number of competitors could result in better outcomes for society.
[5] The Lerner Index measures firms' ability to price above cost and represents a measure of market power.

A review of the economic literature provides an additional conclusion – price regulation of property insurance does not lead to lower prices. Harrington used cross-sectional data from 1972-1998 and found "that on average, prior approval regulation has little or no effect on the relationship between rate levels and claim costs over time, but it did reduce coverage availability and increased volatility for both insurers and consumers."[6] D'Arcy used regression analysis for 1980-1998 data and found that different levels of regulation did not have a statistically significant effect on premiums.[7] Litan and O'Connor used an event study to determine what happened to prices after South Carolina and New Jersey became less strictly regulated and determined that for each state "rates actually declined or did not increase as fast as the national average."[8] They concluded that rate regulation increased claim costs and premiums over the long run. Cummins, Phillips and Tennyson noted that the nature and degree of rate regulation has no statistically significant effect on rates over the long run and could lead to higher rates.[9] Similarly, Tennyson found that premiums in states with high rate regulation are often higher than less stricter forms of regulation.[10]

Furthermore, there is evidence that price regulated states do not have lower prices, have more price fluctuations, have higher industry costs and do not have lower industry profits.[11] In other words, market failures cannot be found, price regulations cannot be justified, and no benefits to consumers have been demonstrated from price controls. In summary, the economic literature finds no evidence of market failure that would warrant price regulation, and empirical studies have concluded that state price regulations are doing more harm than good.

---

[6] Scott E. Harrington, Effects of Prior Approval Rate Regulation of Auto Insurance, Published in J. David Cummings (editor) *Deregulating Property-Liability Insurance: Restoring Competition and Increasing Market Efficiency*, AEI-Brookings Joint Center for Regulatory Studies, Chapter 7, May 2002, p. 7.

[7] Stephen P. D'Arcy, Insurance Price Regulation: the Illinois Experience (Cummins book 2002)

[8] Robert E. Litan and Phil O'Connor, "The Consumer Benefits of an Optional Federal Charter: The Case of Auto Insurance," to be published in a forthcoming volume edited by Martin Grace and Robert Klein, Brookings Institute Press and American Enterprise Institute, Washington, DC, 2009, p. 26.

[9] David Cummins, Richard Phillips and Sharon Tennyson, "Regulation, Political Influence and the Price of Automobile Insurance" *Journal of Insurance Regulation*, vol. 20, 2001, pp. 9-50.

[10] Sharon Tennyson, "The Impact of Rate Regulation on State Automobile Insurance Markets," *Journal of Insurance Regulation*, 15 (1997), pp. 502-523.

[11] Stephen B. Pociask, "Does State Private Passenger Automobile Price Regulation Benefit Consumers? The Myths and Facts," The American Consumer Institute, February 12, 2009.

## Causality

If you look at the handful of states that heavily regulate property insurance prices, you will find states with the highest average premiums; and if you look at the handful of states with no price regulation, you will find states with the lowest average premiums. However, there is a question of causality – did high insurance prices lead to price regulation or did price regulation lead to higher prices? This causality can be tested by looking at how prices change when states deregulate insurance services. In South Carolina and the District of Columbia, auto insurance deregulation in the form of reduced cross-subsidies increased market participation, and reduced average prices.[12] Recently, Massachusetts deregulated the auto insurance market, which led to entry of new competitors and reports of prices falling by as much as 40%.[13] If price regulations are intended to keep policyholder prices low, then they have failed miserably. Thus, there is a mounting record of evidence that the removal of price regulations causes prices to fall for consumers, even while it stabilizes the market, increases market participation and improves the ability of insurers to pay catastrophic claims.

A second way to test for causality is to correct for things that would normally increase insurance prices, such as coastal exposure to hurricanes and other factors, and then examine the remaining cost differences between regulated and unregulated states. In March 2008, the American Consumer Institute analyzed the effects of regulation on auto and homeowners insurance, while controlling for factors such as income, coastal exposure to natural disasters and crime. Their report found that higher levels of regulation lead to higher consumer premiums.[14] The statistical analysis found that the average household pays about $300 more for property and casualty insurance in heavily regulated states, compared to those in less regulated states. In total, excessive regulations

[12] For example see Scott E. Harrington, "Insurance Rate Deregulation" (conference presentation, AEI, Washington, DC, September 21, 2006); and Peter Wallison, "Groundhog Day: Reliving Deregulation Debates," AEI Outlook Services, The American Enterprise Institute, Washington DC, October 2006, http://www.aei.org/outlook/25034.

[13] Jeffry Krasner, "Largest US Insurance Joins Mass. Market," *Boston Globe*, July 12, 2008, available at http://www.boston.com/business/articles/2008/07/12/largest_us_insurer_joins_mass_market.

[14] "The Biggest Losers and the Cost of Insurance Regulation," ***ConsumerGram***, The American Consumer Institute, March 27, 2008.

across the U.S. were estimated to raise consumer property and casualty insurance premiums by approximately $13.7 billion per year.[15] This statistical analysis confirms that the factors contributing to higher insurance prices are not sufficient to account for all of the differences in state premiums and that price regulation is a significant explanatory variable for the increase in state insurance prices. In summary, more stringent price regulation of insurance means higher expenditures for consumers.

## Regulatory Death Spiral: The Case of Florida

The previous section showed that there is no other market failure or economic rational to justify price regulation, and that these regulations are likely to create more harm than good. This section will focus on the consequences of price regulation in Florida to show that price regulation can have a cascading effect that ruins beneficial market forces, raises industry costs and consumer prices, pushes solvent firms out of the market for less solvent ones, and leaves a dysfunctional market that reduces consumer welfare. Texas appears to be following the same course.[16]

Normally, when firms set prices too high, other firms will undercut their prices and win market share. Alternatively, when firms set prices too low, they lose money and must raise prices back toward market equilibrium or they will exit the market. This is how competitive markets work and how consumers benefit from price competition.

Now introduce a scenario where regulators set prices. Because regulators cannot perfectly guess all of the time exactly where prices should be and, for this reason and as noted earlier, regulated prices fluctuate with greater variation than in unregulated markets. This means that regulators can make mistakes and diverge from efficient pricing that would maximize social welfare minimal costs. For example, if regulators opt to set prices too high, then regulations are price gouging consumers; alternatively, if regulators opt to set prices too low, insurance companies are getting squeezed – both

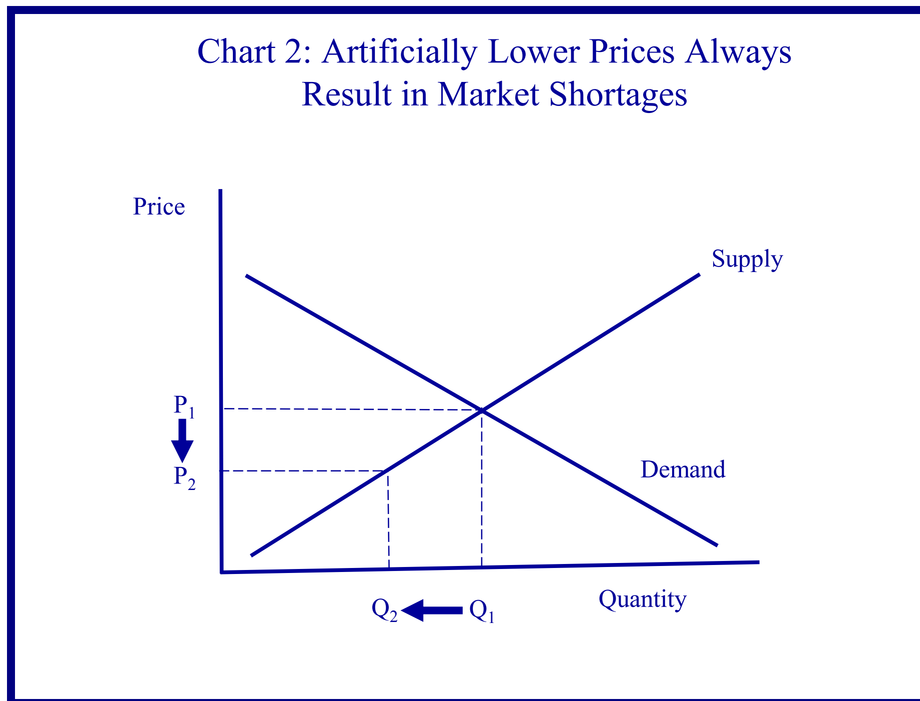
---

[15] Ibid.

[16] Stephen B. Pociask, "Will Texans Pay More for Less? How Insurance Price Regulation Poses Adverse Consequences on Texas Consumers, ConsumerGram, The American Consumer Institute, Forthcoming.

options have disastrous consequences. To illustrate the effects of price regulation, assume regulators will set prices too low.

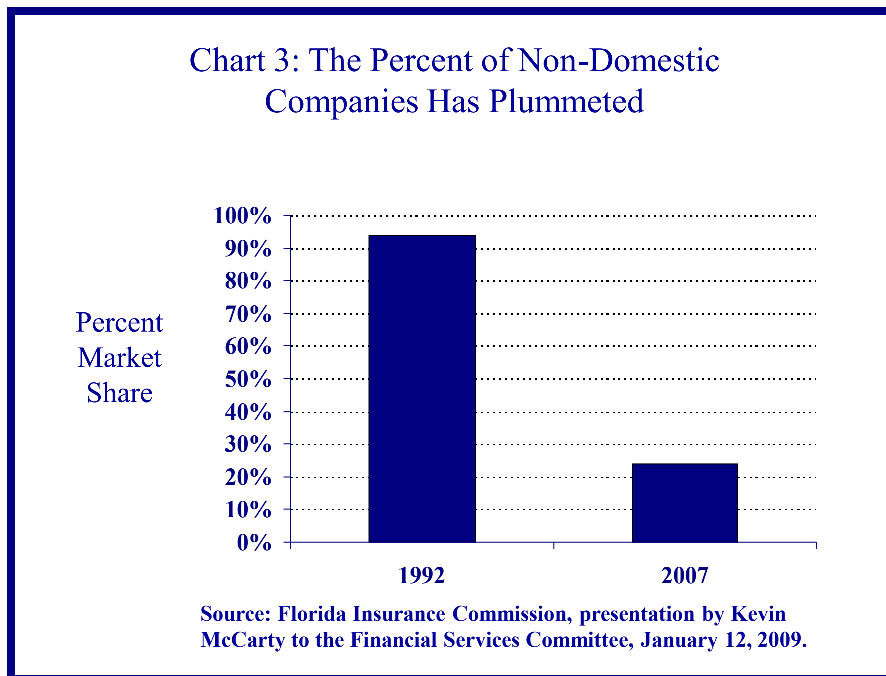
In a competitive market, the basic law of supply and demand shows the determination of market price and quantity demanded. In **Chart 2**, equilibrium price (price set by the market) is $P_1$ and quantity demand is $Q_1$. If regulators determine that the price should be lower, say $P_2$, then given the supply curve, the market will only supply $Q_2$. In other words, when regulators set prices too low, they create shortages whereby insurance firms will not serve all of the market and social welfare, the total benefit that society receives, is reduced.




This is exactly what has occurred in Florida – as firms have left the market, some have chosen not to write new policies and others have pulled out of less profitable areas, particularly coastal areas that are more exposed to storms. Florida Insurance Commission Kevin McCarty aptly noted "[Insurance] companies are pulling away from

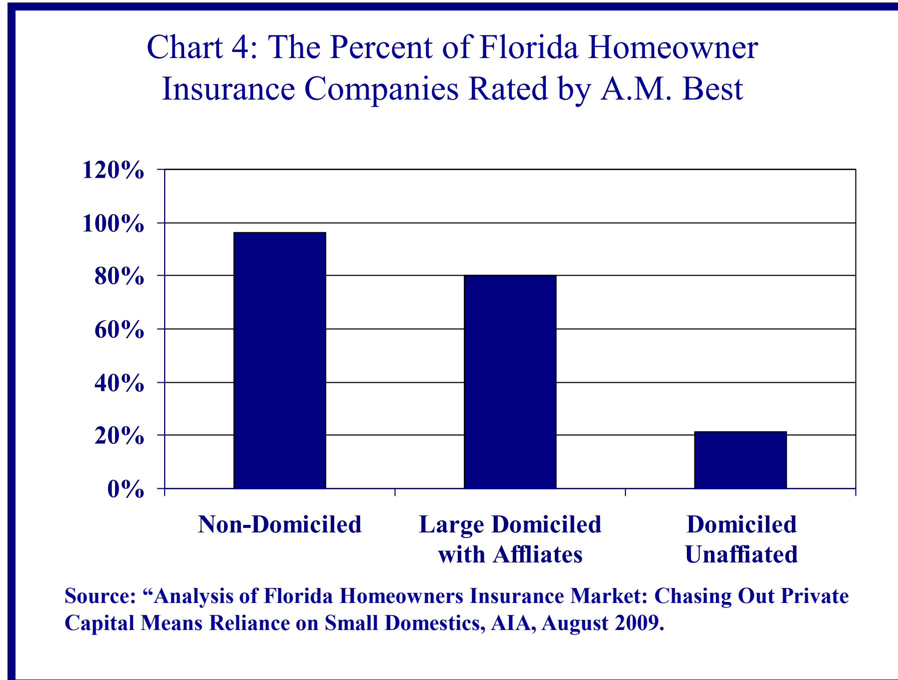
catastrophe exposed areas and residual markets are growing."[17] However, instead of realizing that price regulations created these shortages, regulators continue to cite unspecified market failures – such as suggesting that the market is not serving all consumers and citing the need for further government intervention. Ironically, it was price regulation that caused these shortages in the first place – not market failure.

In Florida, price regulation has continued, and Citizens, the state-run insurance carrier of last resort, was given the task to address the shortage and serve unprofitable coastal areas through a subsidy scheme that made other policyholders pay the difference. Thus, private insurers continued to retrench as inland rates increased, consumers paid more from price regulation, and Citizens became the largest homeowner insurer in the state. But these costs have fed the death spiral, and larger multi-state insurers continued exiting the market, thereby leaving smaller firms behind. As **Chart 3** shows, over a fifteen year period, the percent of large, multi-state and well-capitalized Florida firms (so-called *non-domestic* or *foreign insurers*) have decreased from 94% to 24%.




[17] Kevin McCarty, Presentation to the Financial Services Committee, January 13, 2009. The term residual market refers to a growing segment of consumers that require subsidized prices, since the insurers will not supply policies at below market prices.

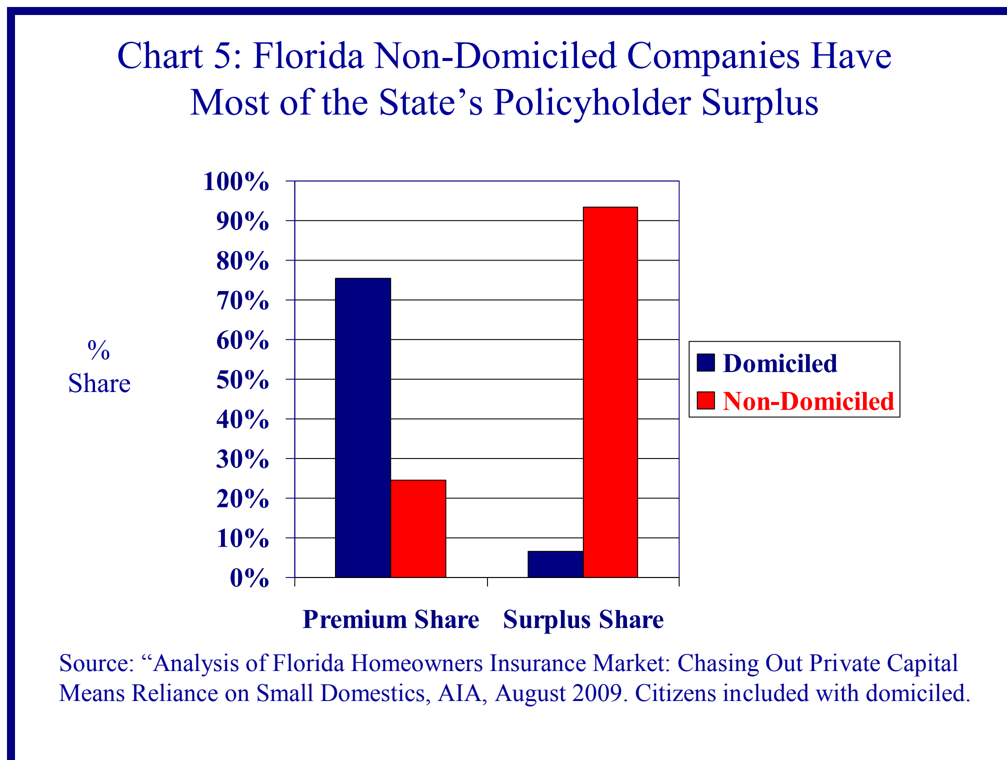
Effectively, price regulation is responsible for changing the composition of market participants from larger, multi-state insurers to single state insurers (referred to as *domestic* or *domiciled insurers*) and generally smaller insurers. Unfortunately, these changes have had adverse consequences on industry cost structure, consumer prices and market solvency. For instance, non-domiciled firms, those headquartered in other states, are much more likely to have a rating status by A.M. Best, suggesting these firms as being more financially stable and recognized brands. As **Chart 4** (below) shows, while 76 of 79 large non-domiciled companies in Florida were rated, 12 of 15 large domiciled companies (those with affiliates and subsidiaries) were rated and, of the generally smallest firms, only 10 of 47 domiciled companies with no affiliates were rated. This means that policies which pushed multistate firms out of the market have changed the "mix" of firms in Florida – pushing well-known and generally financially stable multi-state insurers out of the market, opting in favor of lesser known, smaller and perhaps weaker insurers.




Source: "Analysis of Florida Homeowners Insurance Market: Chasing Out Private Capital Means Reliance on Small Domestics, AIA, August 2009.

If price regulation results in smaller and sometimes financially weaker insurers, then we should expect to see this in the financial data, and **Chart 5** (below) shows

exactly this problem. Because larger multi-state providers are pulling out of the Florida market, domiciled companies (including Citizens) now dominate the share of premiums in the state, but they account for a small fraction of policyholder surplus, demonstrating a growing inability of insurers to back consumer claims. Thus, Florida's policy of reducing or suppressing prices has changed the composition of insurers from (on average) financially stable firms to less stable ones. This means that somewhat lower prices have led to a surplus-starved market, where industry reserves may not cover policyholders in the event of major catastrophes.



Source: "Analysis of Florida Homeowners Insurance Market: Chasing Out Private Capital Means Reliance on Small Domestics, AIA, August 2009. Citizens included with domiciled.

At this point, a major problem emerges -- low surplus requires even higher increases in premiums than before, but regulators want to cap prices. In fact, Florida now leads the nation in insurance insolvencies.[18] Although there has not been major hurricane

[18] For example see "Florida Property Insurance: Northern Capital Loses Rating; HomeWise Consolidates, *Insurance Journal*, February 24, 2010; "Insurers Leave Homeowners at Risk," *Sarasota Herald-Tribune*, February 26, 2010; Paige St. John, "Home Insurance Industry is Fraught with Risks," *Lakeland Ledger*, February 28, 2010; "More New Florida Property Insurers in Trouble," The Associated Press, March 9, 2010; "Florida's Unacceptable Risk: Legislature Should Require Insurers to Have the Means to Cover

to hit Florida in more than 5 years, recent insolvencies have surpassed the number of insurers in trouble during the 2004 to 2005 period when eight hurricanes hit Florida.[19] In fact, in 2010, reports suggested that most of the state's insurers were not on solid financial footing, and some were "incapable of paying house fires let alone hurricanes."[20] This indicates that storm costs are not the cause of Florida's solvency problems; it can only be due to price regulations that are preventing insurers from building surplus. The end result has sent solvent insurers packing and left consumers worse off.

Changes to the mix of insurers result in higher consumer costs, not lower prices as some would hope. Because of the law of large numbers, large insurers have a higher probability of their actual losses equaling their expected losses, and these larger multi-state insurers are better diversified.[21] This advantage gives larger insurers the ability to price very competitively without excessive risk taking. Small insurers do not have this advantage, which means that they are more at risk and require a higher percentage of surplus than larger insurers. Small Florida domestics are at huge risk, since a large portion of their customers can be affected by a single storm. Therefore, they need more surplus as a percent of assets, compared to larger firms. This is, in fact, born out by the data.

Using data for 3,587 insurance companies in the U.S. for 2009 (covering all lines of business), as shown in **Chart 6** (below) large firms (shown in the lower deciles) can

---

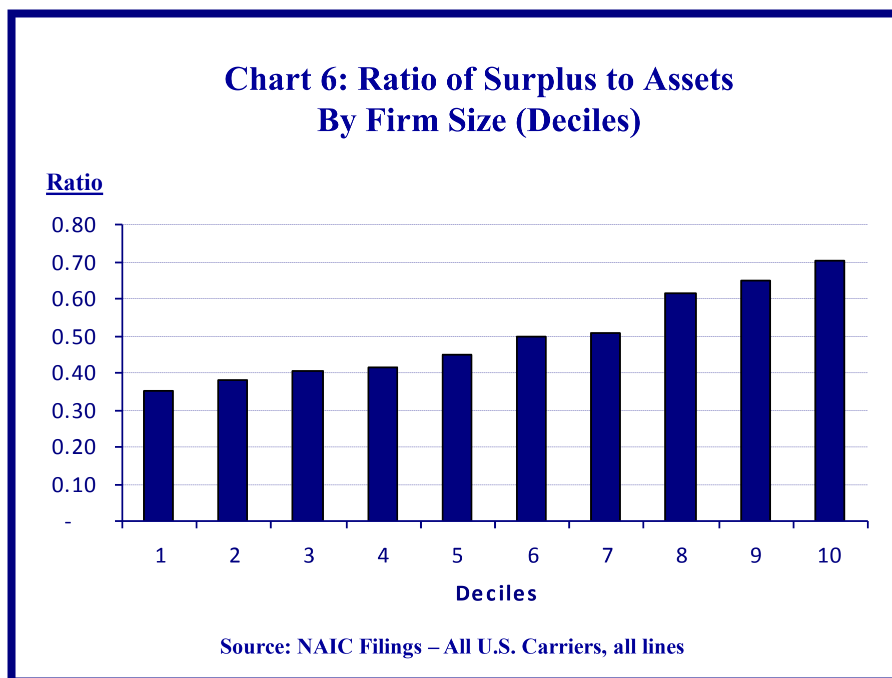
Their Policyholders," editorial, *Sarasota Herald-Tribune*, March 7, 2010; "Another Florida Insurer Faces Suspension: Olympus Insurance," *South Florida Sun-Sentinel*, April 9, 2010; "Loose Reins, Despite Concerns: Three Examples," *Sarasota Herald Tribune*, April 18, 2010 (discusses Magnolia Insurance, Edison Insurance and Northern Capital); and Paige St. John, "Florida Rolling Dice on Insurers," *Sarasota Herald-Tribune*, May 3, 2010, p. A1..

[19] Paige St. John, "Special Report: Weak Insurers Put Floridians at Risk," *Sarasota Herald-Tribune*, February 28, 2010, writes: "After eight hurricanes swept through Florida in 2004 and 2005, five insurance companies failed." In this article, she goes on to point out that 42 of 70 homeowner insurers at risk, and only 30 out of 70 appearing financially sound. The footnote above highlights some of the more recent news reports of insolvencies.

[20] Ibid.

[21] In probability theory, as a sample of trials increases, the average of the trial result approaches (equals) the expected value. Similarly, as the number of policyholders increases, the insurer is better able to predict expected losses from claims, which makes capital requirements more predictable. Thus, as firm size increases, variation and risk are reduced.

hold less surplus as a percent of assets compared to smaller firms (shown in the upper deciles). As a result, when policies change the overall composition of firms from larger multistate insurers to smaller domestic insurers, it can have the unintended consequence of changing the entire cost structure of the industry, raising market risk and cost, and eventually leading to higher consumer prices. However, rate regulation will not permit higher prices, so these smaller firms are stuck, leaving consumers to choose among more risky and sometimes financially weak firms.

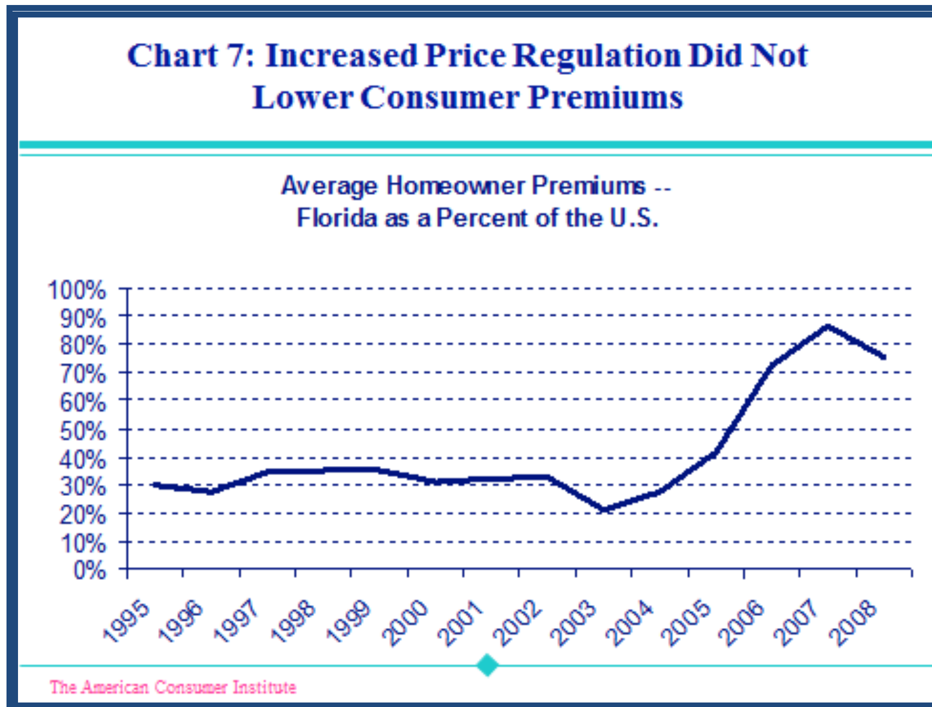


Source: NAIC Filings – All U.S. Carriers, all lines

States with price regulation have higher costs and higher prices. Some of these higher costs could be due to the higher cost structure of the market brought on by regulation. Higher costs could result from higher market and regulatory risks. It could also be that firms are reluctant to lower prices, since they (later) will be unable to increase them. Higher rates could be due to increased regulatory monitoring and compliance costs, fees and other expenses that are passed along to the industry and consumers. It could also be due to mandated coverage requirements. Also, as mentioned, shortfalls by Citizens are pushed to consumers as surcharges on their premiums. Longer term, subsidizing coastal insurance creates demand for coastal

property and encourages excess building in risky areas, which means that more property is put at risk and liabilities go up. In Florida, the lack of mitigation programs, insurance fraud, failure to reform bad faith laws, trial lawyer abuse (related to sinkhole claims) and the outmoded public adjuster processes have increased insurer costs, eventually increasing homeowner insurance premiums.

In other words, while Florida regulation attempts to keep prices low, failure to reduce these cost drivers results in higher consumer prices. That leaves consumers worse off – paying more for price regulation. In the last 15 years, Florida homeowners' premiums have increased to be the highest in the nation; and, as **Chart 7** shows, whereas consumers once paid 30% above the national average, they now pay nearly 90% more. This is a testament to the fact that price regulation does not work and that it eventually destroys a functioning and efficient private market. This leaves consumers stuck with higher prices and less solvent insurers or the public option (Citizens). If insurers are less solvent, then what exactly is the benefit of insurance regulation – higher consumer prices and firms that cannot pay claims?



The result of all of this is a regulatory death spiral brought on by policymakers' desire to manipulate market prices – maybe for short term political gain. As demonstrated in this paper, price regulation does not work. Low prices lead to shortages, which mean that some consumers cannot find insurance. Then, regulators try to manipulate supply by operating their own state-run insurance and re-insurance companies. All of this drives out capital and leaves the market poorer and, longer term, more costly to serve. Now consumers are stuck in a worse situation – pay more and get less in return.

Essentially, the Florida insurance market is in trouble because of onerous price regulations – solvencies are up, firms are leaving and Citizens may not have enough surplus to protect consumers against a major storm. Ironically, in the absence of price regulation, the private insurance market could have secured all of the global capital necessary to cover policyholders.

## Instead of Price Regulation – Consumers Deserve Solvency Regulation

When regulations set artificially low prices, this study shows that it does not benefit consumers, nor does it satisfy the true justification for insurance regulation, stated some eighty-five years ago by the Nation's leading legal scholar of insurance regulatory matters:

> *The chief object in view in creating separate insurance departments and in delegating to them extensive powers of regulation and investigation was to protect the public against financially unsound enterprises; and this remains the chief raison d'être of the insurance commissioner.*[22]

Yet, somehow, the reasons for regulation have changed and the outcomes from regulation have not changed for the better. The effectiveness of regulation should in the first instance be judged on the extent to which

[22] Edwin W. Patterson, The Insurance Commissioner in the United States, A Study in Administrative Law and Practice (Cambridge, MA: Harvard University Press, 1927), p. 92.

regulators hold insurers accountable for honoring the promises they make and for paying legitimate claims by requiring that they have the funds to pay these claims. To be able to do so, firms must be solvent.

Insurance regulators should develop appropriate reserve policies and investment activities. Consumers ultimately must rely on regulators to put in place rules to assure that legitimate claims are paid and that insurers are financially able to do so. Insurance contracts are complex enough without consumers having to do the financial analysis and risk assessment required to inform a judgment about the insurers' financial structure and approaches to risk management. Most consumers, as well as insurers, strongly favor solvency regulation to prevent undercapitalized, fly-by-night, firms from entering the market, undercutting prices, raking in large profits, and then disappearing or becoming insolvent when too many claims are made.

As first steps toward increased solvency, Florida policymakers should focus on getting capital back into the market, but to do so may require some transitioning. Returning the Florida insurance market back to private insurers can be accomplished by the following:

- Changing the focus from price regulation to solvency regulation;
- Transitioning prices using a flex-rating system;
- Reducing the size of Citizens and raise Citizens' rates toward actuarially sound levels; and
- Resizing the state catastrophe fund based on the size of its Capital, not its debt.

In addition to encouraging private capital back into the market and encouraging competition as a means of eventually lowering consumer prices and improving solvency, policymakers need to keep insurer costs low by reducing fraud and waste. For example, insurers often pay claims without the damages ever being repaired which invites fraud.

Sinkholes have become a major cost driver in the industry that has required insurers to pay, in some cases, questionable claims. This has led to some to call for a new government funded solution to deal with fraud and other issues. However, rather than creating another inefficient government solution, policymakers need to address ways to reduce private insurer costs, while protecting consumers with legitimate claims. This can be done by reforming bad faith laws, requiring that insurers pay for repairs made, and stopping trial lawyer abuse.

There are also other ways to lower insurer costs without sacrificing consumer benefits. Mitigation policies are one way to do this by incentivizing consumers, through lower insurance premiums, to upgrade or make repairs that will better improve their home and safety, in case a storm hits. In addition, policymakers should consider public adjuster reforms that delink the value of damage claims with adjuster fees.

In short, encouraging capital back into the market, transitioning rates towards actuarially sound levels, reducing government's role in providing insurance and reinsurance, and reducing insurer costs are among several ways to get Florida back on track and focused on solvency, not price regulation. That will lead to lower consumer prices and increased competition in the market.

## Conclusion

The simplest solution is for regulators to let the market work and avoid price regulation, instead focusing their scrutiny on solvency regulation. A first principle of effective insurance regulation is to focus on the primary need of consumers to be paid when they make a claim. Through the market process, consumers are perfectly capable of putting pressure on firms to lower prices. But consumers are less able to judge the financial stability of firms to deliver on their contractual obligation to pay claims. This is where the government can add value and efficiency to the market. So regulators should

focus first and foremost on solvency and leave the price regulation to individual consumers.

For those states already facing problems, the solution is hard and obvious – price deregulation. By increasing rates slowly over a multi-year period, markets can be restored, firms can reenter the market and policy surplus can grow. As the market returns to health, price competition will flourish and put downward pressure on prices. This will end shortages and relieve the need for large state-owned insurers. While these measures may lead to a short-term increase in insurance prices, in the end, consumers will have more affordable insurance options and safer ones too.

This analysis has shown that price regulation undermines the most important role of regulators – to make sure that legitimate claims are paid. If claims are not paid due to insolvency, then what is the purpose of insurance?

## ABOUT THE AUTHOR

### Stephen Pociask

Mr. Pociask is president of the American Consumer Institute Center for Citizen Research. He has published numerous economic studies, including three books for the Economic Policy Institute, and policy studies for numerous independent nonprofit organizations. Many of his research studies have focused the consequences of public policies on consumers and consumer welfare. His research topics include energy, insurance, consumer products, information technology and healthcare.

He has also written reports for the Small Business Administration's Office of Advocacy, testified before Congress, and appeared numerous times in the media, including Bloomberg News, CNBC, NBC, Fox, Congressional Quarterly, New York Times, and CNET Radio.

Over the years, Mr. Pociask has provided consulting to TeleNomic Research. From 1998 to 2000, he served as chief economist and executive vice president for Joel Popkin and Company. Prior to these assignments, he was chief economist for Bell Atlantic Corporation. He has completed his Ph.D. coursework in economics and has an M.A. in economics from George Mason University.