

Are You In Good Hands?

How home insurance companies in Texas ripped you off—and why it might not happen again.

Dave Mann | December 12, 2008 | Features

Rick Perry was talking tough. It was August 5, 2002, and the Texas governor had been joined at a news conference in Houston by John Cornyn, the state's attorney general. They announced to the assembled reporters that the state had sued Farmers Insurance, one of Texas' most prolific writers of home insurance policies, for deceptive trade practices. Cornyn's office had been investigating the home insurance market, where premiums had ballooned out of control. And now the state had made its first case.

"The investigations are still ongoing, but the findings reflect that at least one company—Farmers Insurance—has engaged in unfair, discriminatory practices to charge consumers excessive and unjustified rates," Perry told the press. The company, Cornyn added, "has put its own financial gain ahead of the well being of Texans. You don't do that in Texas."

But, of course, they had been doing it. In 2002, Texans were paying, on average, the nation's highest rates for homeowners insurance. That was an impressive feat, given that prices for homes in Texas lagged far behind those in California, New York and Florida. In the previous two years, the state's big insurers had jacked up premiums. Insurance companies said they were bleeding money from too many expensive claims. But they also had ruthlessly exploited a loophole in state law that allowed them to raise rates unfettered by regulation.

While Perry and Cornyn had ostensibly come to Houston to announce a civil court filing, the political overtones were obvious. The two Republicans were on the November ballot—Perry running for his first full term as governor and Cornyn aiming for the U.S. Senate—and with Election Day just three months off, home insurance had become the 2002 campaign season's top issue. Texas homeowners were seething. They wanted their rates cut fast.

It was a particularly perilous issue for Perry. He was favored to win. But his Democratic opponent, Tony Sanchez, had seized on the crisis and begun a populist call for stricter regulation that would force the insurers to lower premiums. He hammered Perry for sitting idly by while rates climbed. Sanchez's campaign was clumsy at times—he named his campaign bus the "Lower Rates Express"—but Perry clearly saw a dangerous political issue.

The governor quickly devised his own reform plan and began criticizing the industry's greed. Perry, an avowed free-marketeer, seemed an unlikely politician to crack down on big insurance companies. Texas Republicans have long found common cause with the insurance industry against Democratic-leaning trial lawyers, and Perry had received more than \$1 million in campaign contributions from insurers at that point in his career.

Yet at nearly every campaign appearance, the governor promised to re-regulate the market and slash premiums. "If the industry hasn't figured this out, listen up," Perry told reporters at one point in the 2002 campaign. "Texans are fed up, and I will sign legislation that prevents a handful of companies from bringing the state to its knees. I am offering solutions that put Texans first. I call on the industry to do the same."

Six years later, Texans are still paying the highest rates for home insurance in the country. The industry has earned billions more than it would have if stricter regulation had been imposed, according to consumer groups; in 2004 alone, the added profit was \$4 billion. In 2006, Texas insurers enjoyed one of their most profitable years on record.

The problem wasn't inaction. Perry and the Legislature passed a sweeping, complicated reform bill in 2003. But the legislation was crafted largely by lobbyists for the insurance industry, imposing the lightest possible regulation. The state remains nearly powerless; insurers in Texas can raise rates by simply notifying regulators.

In January, the Legislature will once again take up home insurance. Six years after siding with the industry, lawmakers will have another chance to fix the system. While the insurance companies will almost assuredly run a similar play—wouldn't you?—the political environment appears to have changed. Some key legislators are already talking about the need for more regulation. The 2009 session may be consumers' best chance for meaningful reform in a very long time—assuming history doesn't repeat itself.

On August 21, 2002, just two weeks after Perry and Cornyn filed their lawsuit, representatives of the largest insurance companies in Texas, including the big four of Farmers, Allstate, State Farm, and USAA, received a fundraising letter from Bill Hammond, president of the Texas Association of Business (TAB). The business group was stockpiling money for an ad campaign that would deliver four million mailers to aid a slate of 22 Republican candidates. The mailing campaign was part of a highly coordinated effort, fronted by then-Congressman Tom DeLay, to capture the Texas House for the GOP and elect Midland's Tom Craddick speaker. The highly partisan Craddick was a controversial choice. His backers knew they would need a supermajority to install him. To elect that many Republicans would require a lot of campaign money. For that, they turned, in part, to the insurance industry.

Hammond's letter made clear why big insurers should support the Republican slate: "While this program is costly, there is no doubt that this is a real opportunity to make a difference in the political climate in Austin."

The industry responded. Insurance interests accounted for \$237,000 of the \$1.7 million worth of mailers attacking Democrats that TAB sent out in the months before the election, as reported by the Austin American-Statesman. (Spending corporate money on campaigns is illegal in Texas, and TAB and some of its funders would later be indicted for their actions in 2002, as would DeLay.) Farmers (\$150,000) also contributed money to DeLay's Texans for a Republican Majority. On Election Day, nearly all the candidates backed by the DeLay operation won, boosting Craddick into power at the head of a 26-seat Republican majority.

In all, big insurers in Texas spent at least \$1.1 million in the 2002 election to support Republican legislators, Perry and Lt. Gov. David Dewhurst. This was highly out of character. Insurance interests have rarely played such a large role in Texas campaigns. But in 2002, the industry badly needed friendly politicians in power.

Home insurance rates in Texas had begun to rise sharply in 1999. The excuse was partly a rash of mold claims filed across the state. But the industry had also lost a bundle in the stock market when the tech

bubble collapsed. Consumer advocates had seen this before: when insurance companies lose big in the stock market, they invariably try to cover the investment losses by raising rates on consumers. And in Texas at the time, the industry could gorge itself on rate hikes because of a quirk in state law known as the Lloyd's loophole.

This gets complicated—as is often the case with insurance policy—but essentially state law at the time left a certain type of insurance policy, known as Lloyd's policies, unregulated. These were policies originally meant for homes that had unpredictable risk, perhaps because of their high value or because of where they were located. Once the secret got out, though, nearly every insurer in Texas began shifting as many homes as possible into Lloyd's policies to escape the reach of state regulators. By 2002, about 95 percent of home insurance policies in the state were unregulated. And like teenagers who had suddenly escaped their parent's supervision, insurers hiked rates—in some cases doubling premiums.

With the insurance market in crisis, some level of reform was inevitable. The market would have to be re-regulated and the Lloyd's loophole closed. The political environment demanded it. The open question was just how stringent the new regulatory structure would be. Many Democrats were touting forced rate rollbacks. They also wanted a reform package that would empower the Texas Department of Insurance to approve rates before companies could put them into effect. This approach is known as “prior approval.” For the industry, it sounded as pleasant as dental surgery.

Big insurers much preferred the plan that Perry put forth: “File-and-use.” Under this system, insurers can raise rates without approval and simply have to notify regulators of their premium increases. Proponents say file-and-use allows the market to set the rates and improves competition, which, they say, leads to lower premiums.

Not long after Election Day, it became clear that insurers would have big sway during the upcoming legislative session. In November, after Craddick claimed the speakership, he appointed a transition team, three men who would serve as gatekeepers to the speaker's office throughout 2003. Two of those men were political consultant Bill Miller, a Craddick confidant who was a spokesman for Farmers at the time, and Bill Messer, a lobbyist for State Farm.

The insurance industry has always exerted influence at the Texas Capitol, but the past five years, beginning in 2003, have perhaps been the zenith. The handful of consumer advocates who lobbied for stricter regulation during the 2003 session recall being run over. The insurance industry had several hundred lobbyists working on its behalf, an army of influence peddlers who had little trouble winning over free-market Republicans, many of whom had been elected for the first time thanks in part to insurance money.

The GOP leadership stacked the insurance committees in the House and Senate with industry-friendly Republicans. Stringent reforms proposed by some Democrats went nowhere. Instead, the main reform legislation—known as Senate Bill 14—sailed through. The bill re-regulated the market by closing the Lloyd's loophole but also instituted the more lenient file-and-use approach favored by Perry and the Republican leadership (not to mention the industry).

When SB 14 landed in a conference committee to reconcile it with the House version, the industry's reps got their way even more. Several consumer protections were stripped out. (Consumer advocates say the

conference committee was stacked against them. Then-Rep. Joe Nixon, a Houston Republican, was included on the committee, though he had worked little on home insurance during the session. It later came out that Nixon was negotiating with Farmers on a mold claim on his own house at the same time he served on the conference committee that was designing a regulatory framework for the company.)

“The way I think of file-and-use, you’re really playing catch-up with the insurance companies,” says Ware Wendell, an Austin lawyer who represents consumers in insurance cases and worked on insurance issues for Rep. Steve Wolens, a Dallas Democrat, during the 2003 session. Under SB 14, if the Insurance Department concludes that a company has been overcharging, it can take that company to court to win rebates for customers. The idea, says House Insurance Committee Chairman John Smithee, the Amarillo Republican who sponsored SB 14, was “to make the first line of defense the competitive market, but when that didn’t work, to have a safety valve where you’d have some adult supervision where the commissioner could step in and regulate.”

The problem is that even when regulators have challenged insurers, they have found it difficult to force companies to surrender their profits.

Since 2003, a few companies have reached settlements with the Insurance Department after regulators took them to court. Allstate, for example, settled a case in May for \$51 million for overcharges in the past four years. More than 700,000 consumers will split rebates worth \$37 million. That’s a whopping average of \$53 each—not much, considering that the average annual premium in Texas tops \$1,200. Allstate also agreed to lower rates by 3 percent. (In 2007 alone, Allstate raised rates 6 percent.) Meanwhile, Perry and Cornyn’s lawsuit against Farmers was quickly settled in 2003 for \$117 million. About \$82 million of that amount would be paid back to consumers.

The largest home insurer in Texas, State Farm, has never been forced to lower rates. The company and its team of lawyers have battled the Insurance Department in court for four years now. In the latest ruling this fall, State Farm won an appellate decision that sent the case back to square one. It remains in doubt whether the company, which handles 30 percent of the state’s market, will ever reduce its rates or be forced to pay back overcharges.

“If they spend a million, two million in legal fees along the way but they save 100 million in overcharges, that’s a winning economic proposition,” Wendell says.

The details of insurance policy are nearly incomprehensible to anyone but the most committed. But the end results are easy enough to judge. Did the rates drop by the 12 to 18 percent the industry promised during the debate on SB 14? No.

SB 14 did have some positive effects. More companies began writing home insurance policies in Texas, though they make up such a small percentage of the market that consumer advocates say true competition doesn’t really exist. In 2003 and 2004, many companies did reduce rates a little. The Insurance Department reported that by 2006, 35 of the 37 companies in Texas had cut rates, though some by only a few percent. But two of the biggest insurers, State Farm and Farmers, didn’t lower rates at all, and together they make up about 40 percent of the market. In all, rates dropped about 4 percent by 2006, nowhere close to the reductions promised by the industry. And in the past two years, some homeowners

have seen their rates tick back up. In April 2008, State Farm announced an increase of nearly 3 percent. Farmers implemented a 10 percent increase in October.

Looking at the market as a whole, rates have roughly leveled off since 2002, says Alex Winslow, director of the consumer advocacy group Texas Watch. Premiums are just a tad below the 2002 levels that helped fuel the insurance crisis.

But Texas still leads the nation in homeowners insurance rates: The average premium is \$1,200 to \$1,300. The only state even close to that level is Louisiana, with average premiums of \$1,100. The national average is about \$800.

While it was touted as “re-regulation,” SB 14 also deregulated insurance policies. Before 2003, insurers offered only a handful of plans. Now companies sell a wide range of complex policies. The industry argued in 2003 that not everyone needed a “Cadillac” plan, and that more options in the market place would fuel competition and drive down prices. But Winslow says that the new insurance policies simply offer less. With rates remaining mostly constant, Texas consumers have continued paying high prices for less coverage.

The policies have become so complicated that most consumers don’t know what’s in their plan. The complexity makes it nearly impossible for average homeowners to comparison-shop. Even the experts have trouble.

“If you ask me what endorsements I have on my policy right now, I couldn’t tell you,” says Wendell, the consumer lawyer. “They send you one piece of paper at a time, saying your policy has been changed to endorsement E-1743, and you’re trying to ask yourself, ‘OK, what does that mean?’ I think choice is great, but you can easily become paralyzed by it.”

The industry loves it. With Texas homeowners receiving less coverage, the insurance industry has paid out less and less money in claims. Even with an occasional spike following Hurricane Rita (and presumably Ike, though the numbers aren’t public yet), Texas insurers were paying out an average of \$400 worth of claims per policy in 2007, down from nearly \$800 in 2001. Remember that the average premium is more than \$1,200. Everything between the \$400 paid out in claims and the \$1,200 received in premiums is profit—which translates to roughly \$800 in profit on average on each homeowners policy in Texas, minus overhead, according to calculations by Texas Watch.

So it’s no surprise that insurers want to maintain the system. Industry groups argue that the file-and-use approach is just beginning to take effect and should be given more time to work.

They also contend that high premiums are needed to cover the costs of major weather disasters in Texas. But other large states suffer weather catastrophes, and homeowners still pay much less for insurance. “Every time I turn on the TV, something apocalyptic is happening in California,” says Wendell. “You have hurricanes brutalizing Florida. And yet their rates are not what we have in Texas.” Floridians pay an average of about \$1,000 per premium. In California, it’s \$800 to \$900. In both states the homes being insured are, on average, far more expensive than those in Texas.

For his part, Smithee, the man who carried SB 14, believes the system has created a more competitive market, but adds that insurers have clearly overcharged consumers in recent years. Smithee has tried to

balance industry needs with those of consumers but sometimes finds himself outvoted by industry-friendly members on his committee. He says that Texas' severe weather does lead to higher rates. "We're always going to be at or near the highest in the nation," he says. "Our losses are just so much higher than other states'." But he concedes that the regulation laid out by SB 14 wasn't strong enough. "We can't just turn this whole market loose and say it will work on its own," he says. "It will probably work most of the time. But in those times when the competition doesn't work, the consumer is very vulnerable."

In 2009 when the Legislature once again debates homeowners insurance, consumers will have an all-too-rare chance at genuine reform.

In the two legislative sessions since 2003, Speaker Craddick made sure that few reform bills escaped the House Insurance Committee to come up for votes in the full House.

But next year the dynamic will change for two reasons. The House is more closely divided, meaning Craddick may not be speaker, which may give Smithee more leeway. More important, the Insurance Department is undergoing sunset review, the regular process by which the Legislature examines state agencies. That ensures that an insurance bill will move through the Legislature. Many Democrats and Republicans, having heard from angry homeowners in their districts, are pushing for more stringent regulation. With foreclosures on the rise in Texas, many lawmakers realize that reducing consumers' insurance bills may allow more folks to keep their homes.

Several lawmakers have indicated they will try to pass a prior-approval system. In September, state Sen. Juan Hinojosa tried to convince the 12 members of the Sunset Committee to recommend a prior-approval system. The measure lost, but by just one vote. The sunset panel's recommendations will be the starting point when the Legislature convenes in January. Where the debate goes from there is anyone's guess.

Consumer advocates would like a prior-approval system. They also want the number of available insurance policies reduced and the state's insurance commissioner to be chosen through election instead of appointment by the governor, a change that has worked well in California.

Smithee is advocating a compromise plan. He wants to strengthen the Insurance Department's hand but worries about the dangers of too much regulation, which, he says, could drive companies out of the market. Smithee would prefer a hybrid approach in which most companies must obtain prior approval for their rates, but the Insurance Department could shift select insurers (who have proved good actors) into a file-and-use system to spur competition.

Not surprisingly, the industry wants even more deregulation, which Smithee says would be a "big mistake." The insurance industry's influence hasn't diminished. It will once again employ some of the most skilled lobbyists in the Capitol. And much will depend on who wins the House speaker's race.

As Winslow of Texas Watch points out, this is consumers' best chance at reform since 2003. Insurers "are always going to have pull," he says. "But this is as good a [political] environment on this issue as consumers have seen in a long time."

Source: The Texas Observer