

COMPETITION AND INSURANCE RATE REGULATION: TEXAS STYLE

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Insurance regulation has always been a little different in Texas. Since the early 1900s, Texas state government has been immersed in setting insurance prices. This was largely due to concerns that insurers might cut prices to unsustainably low levels to the point where insolvencies would result. In competitive markets, government intervention may be needed to protect against “inadequate” rates and seldom, if ever, necessary to call rates “excessive.” Texas has also been a state that engages in “insurance reform” on a regular basis. Despite all of the political rhetoric surrounding reform, Texas has gradually been moving to adopt laws that seem to rely more on competitive markets to act as a regulator of prices in the business of insurance.

In 2003, Texas insurance reform shifted rate regulation for most lines of property casualty insurance to the “File and Use” law.¹ File and Use was applauded as a “sorely needed step forward in the direction of more competitive insurance markets.”² The Commissioner was also given authority to order refunds of premiums determined to be excessive or unfairly discriminatory.³

The Texas File and Use law is similar to most states where competition is a key factor in rate regulation. However, several actions by the legislature and regulators are contrary to the consideration of competition in the regulation of rates. The Texas Department of Insurance (TDI) often determines whether selected rates are “excessive” based upon its own actuarial methods or logic, which is evidenced in aggressive steps taken by the TDI and the Office of Public Insurance Counsel (OPIC) to force some individual insurers to not only reduce rates but also to retroactively pay refunds.⁴

In 2005 “insurance reform” legislation took a “painful step backward” in using competition. First, the Legislature amended the refund law to allow the Commissioner to order refunds plus interest.⁵ Interest is at the rate of the lesser of prime plus six percent or 18%.⁶ This enhances the authority of the regulator to effectively threaten insurers with punitive actions if rates are not reduced as demanded. Second, the legislature also deleted “competition” as a factor in determining whether medical professional liability rates are excessive.⁷

Despite the fact that individual consumers have many choices in buying insurance in Texas, it appears the important factor of competition may be ignored in determining whether rates are excessive. One of the most important roles of a regulator for all lines of insurance is to assure solvency. However, Texas law also requires the regulator to promote availability and price competition.⁸ Under current law, with the exception of title insurance, the TDI no longer promulgates rates that an individual insurer uses.

With the threat of possible refunds, many insurers may often negotiate rate changes to satisfy a regulator and may adjust their underwriting criteria accordingly to maintain adequate profitability. The element of competition seems to be ignored in this process. As will be explained in this article, it is my belief that competition is still an important factor that must be considered in determining whether a rate is “excessive.”

It should be undisputed that consumers and Texas insurance markets will not be served in the long run if excessive rates are determined by regulatory fiat as opposed to the competitive market. Empirical evidence to support the use of competition as opposed to regulatory suppression is overwhelming. Over-regulation can:

1. Reduce competition;
2. Reduce availability; and,
3. Increase volatility.⁹

I hope this article will provide some insight into both the legal and political landscape in Texas. There will be many “unanswered” questions but I hope this will assist those that do business in Texas.

What is an Excessive Rate?

Excessive is defined as a *rate* that is likely to produce a *long-term profit that is unreasonably high in relation to the insurance coverage provided*.¹⁰ “Long-term profit” is not defined. “Unreasonably high” is not defined. TDI rules provide no definitions. The statute also refers to an excessive “rate,” not the components that comprise a rate. A rate means “*the cost of insurance per exposure unit*.”¹¹ The statute and TDI rules do not define excessiveness based on the components or factors used to determine a rate. Even though the TDI has made profit determinations in past years, the issue of what constitutes an “unreasonable long-term profits” as used to enforce the current law is still an open question.¹²

Both the TDI and OPIC have analyzed rate filings without specific consideration to long-term profitability or the existence and degree of competition in a particular rate filing. Instead, the current practice of TDI and OPIC is to review the various components of the rate as reflected in the documents furnished to support the rate filing. I sometimes refer to this approach as a “component method of analysis,” which is similar to what might be used to evaluate a utility rate filing. This approach may be appropriate for a utility that has some type of monopoly power but the “component” method is not suited for regulating rates in a competitive market. Under a “component method of analysis,” no attempt is made to compare the “rate per exposure unit” for the same or similar coverage in a competitive market.

Under a component method of analysis, the actuary picks out a particular component or element in the information furnished as part of a rate filing to allege that the entire rate is thus excessive. For example, TDI and OPIC may allege the entire rate of a company is excessive. One could certainly argue that this method is inconsistent with the statute which defines excessiveness in terms of the “rate” and not the components that comprise the “rate.”

Evidence on whether the rate is in fact excessive is usually offered in the form of an opinion by an actuary that the “rate” is excessive. The basis for the opinion is that a component, such as the profit factor or the loss trend factor, is too high. This method of analysis is not reflected in the statute or rules and can only be described as some type of “*ad hoc*” rulemaking procedure that will be applied on a case-by-case basis. The use of *ad hoc* rulemaking to enforce or define rate standards is highly questionable under Texas law.¹³ Even more serious constitutional issues are raised, if the “*ad hoc*” standards established through a “component analysis” are used to impose retroactive penalties through refunds or other penalties.¹⁴ Thus, it could be argued that the “component” analysis fails to comply with the statute because it does not focus on whether the “rate” itself violates the standards and definitions as set forth in the statute.

Any analysis of a particular factor in a rate filing would ignore the central economic question of how the *rate* itself, regardless of what the components are that comprise the *rate*, can ever be unreasonably high in a competitive market. For example, one company with very low rates may have a higher profit component than an insurer with higher rates and a lower profit component. An example is Southwest Airlines in the airline industry. It is a very profitable carrier with perhaps the lowest rates. If their rates were regulated, using a “component” method of analysis that focuses only the profit factor, then government regulators would find the “rate” to be excessive and could require a company like Southwest Airlines with the lowest *rates* in a market to reduce *rates*. While this is a hypothetical, unfortunately this is the precise type of thing that is happening in Texas in the regulation of rates under the File and Use law. This seems contrary to the purpose of Texas law to “promote” competition and fundamental economics.

The plain meaning of the term “long-term profit that is unreasonably high” must be construed consistent with the purposes of the statute. One purpose of the File and Use law is to “promote price competition among insurers to provide rates and premiums that are responsive to competitive market conditions.”¹⁵ Competition cannot be promoted if TDI can disapprove even the lowest rates. The very essence of competition is that “unreasonable long-term profits” cannot be achieved because competitors will reduce profits to attract buyers.

As reflected earlier, the evidence used to support a finding of “excessiveness” is usually the opinions of TDI and OPIC experts. This opinion testimony on “excessiveness” is usually based solely on the analysis

about the “components”. While there may be references to actuarial standards, these provide little help in determining whether a certain component is excessive. For example, the expert may say that a 4% profit factor in a rate filing is too high because it results in a 12% return on equity. There is nothing in Texas law or scientific economic literature that says any specific profit factor is unreasonably high. The basis for the opinion is usually based on the “bare opinion” of the testifying expert. Little, if any, consideration is given to the statutory definition of competition.

It can easily be argued that these “bare” opinions are not consistent with accepted economic principles. Any opinion of this type is subject to careful review by the courts to determine if the opinions that are based on reliable factors accepted in the relevant scientific commentary. If not, the evidence is insufficient as a matter of law.

Texas law is clear that “in determining whether an expert’s testimony constitutes some evidence, an expert’s bare opinion will not suffice and the substance of the testimony must be considered.”¹⁶ The underlying data of an expert’s opinion should be independently evaluated in determining if the opinion itself is reliable.¹⁷ The expert’s assertion of validity is not enough; there must be objective, independent validation of the expert’s methodology.¹⁸ Scientific evidence which is not grounded ‘in the methods and procedures of science’ is no more than ‘subjective belief or unsupported speculation.’¹⁹ As such, this would be considered to be unreliable evidence that is of no assistance to the trier of fact and is therefore inadmissible.²⁰ When the reliability of an expert’s testimony is challenged, courts examine the substance of the expert’s testimony to determine if the opinion is based on demonstrable fact and does not rely solely on assumptions, possibility, speculation, and surmise.²¹

A significant legal issue will be whether “bare opinions” of OPIC and TDI experts on the “excessiveness of rates” using only a component method will be reliable. A good question is whether an *unreasonably high long-term profit* can ever be achieved in a competitive market. The relevant scientific economic literature suggests that an unreasonably high long-term profit cannot be achieved in a competitive market.²²

If evidence is offered on the issues of long-term profitability and unreasonably high profits, it is also usually in the form of expert testimony. This is where a future rate case could become interesting. Actuarial testimony is usually accepted as expert testimony but the opinions of an actuary, like any other expert, must also be reliable and based on some scientific or acceptable standard. This issue of competition and long-term profitability can be both an actuarial and economic issue. In either event, testimony must be reliable and based on accepted scientific standards. Thus, the central issue of profitability, as used in the definition of the term excessive in the Texas Insurance Code, should require experts to demonstrate that their opinions are reliable and based upon some objective recognized standard.

Information Filed

Texas law is very general on information required to be included in a rate filing. The statute requires insurers making a rate filing to file “supporting information.”²³ Supporting information is defined as: (1) the experience and judgment of the filer and the experience or information of other insurers relied on by the filer; (2) the interpretation of any other information relied on by the filer; (3) description of the methods used in making rates; and (4) any other information required by the department to be filed.²⁴

The TDI rules require the filing of actuarial information.²⁵ Under this rule, actuarial support includes the rate indications and support including data and methodologies utilized by the insurer to derive indications. The rule requires information to be filed to the extent applicable including premiums at current on-level factors; incurred and paid losses; loss and claim development factors; premium and loss trend factors; rate relativities; catastrophe factors; deductible credits; support for discounts and surcharges; off-balance factors; and expense and profit provisions.²⁶

Data to support a rate filing can include internal data from the particular insurer, industry aggregate data within and outside of Texas, and other external type of indices like the consumer price index that could be used to reflect anticipated loss trends.²⁷

Rates that are “selected” by most insurers are seldom based exclusively on actuarial indications or information. Some insurers may not even use an actuarial analysis but instead select rates based on what larger insurer competitors are charging in a particular market. Most insurers, including large and small insurers, typically select rates that are different than the actuarially indicated rate. Selected rates are invariably based on business decisions that includes the nature and degree of competition. Therefore, it is recommended that any filing to the TDI include business factors that were considered in selecting rates. Business factors could include but not be limited to information about competition in a particular line or information concerning the “rates” of competitors.

Rate Hearings

Rate hearings are only necessary when action is taken to disapprove rates. There are two distinct procedures under Texas law for the TDI to disapprove rates. First, the TDI can initiate a hearing to disapprove a rate that is “in effect” by providing notice for a hearing.²⁸ A rate that is “in effect” cannot be disapproved until after a hearing. Second, rates that are “not in effect” may be disapproved without hearing, but an insurer may request a hearing after receipt of a disapproval order.²⁹ In this type of disapproval, an insurer could not use disapproved rates until after a hearing.

All rate hearings are conducted before the State Office of Administrative Hearings (SOAH). SOAH is a separate state agency that conducts hearings for numerous state agencies. There are over 15 administrative law judges. Each case will be assigned to a specific administrative law judge (ALJ).

Rate hearings are contested case proceedings with the right to discovery and cross examination of witnesses.³⁰ The administrative law judge (ALJ) is a lawyer and will make an initial proposal for decision. This will include detailed findings of fact and conclusions of law. The PFD is then referred to the Commissioner who makes the final decision. The Commissioner can change findings of fact and conclusions of law. A final Commissioner’s order is subject to judicial review.³¹ Any final order disapproving an existing rate is required to state a date on which further use of a rate is prohibited.³² An insurer can continue to use its current rate until a final decision is made.

Conclusion

The current enforcement of File and Use rate laws has apparently ignored competition in determining whether a rate is excessive. This could have long-term adverse consequences as to whether insurers are free to select their own rates in a competitive Texas market. If the TDI can substitute its judgment for insurers based on an *ad hoc* determination of whether a rate is excessive, then Texas’ File and use law may be nothing more than strict prior approval. Under applicable Texas law, an insurer has some excellent legal arguments that can be presented to TDI actions to disapprove rates. It is not impossible for an insurer to achieve a favorable result in an administrative hearing.³³ Texas courts have also been reasonable in applying fundamental law in insurance cases.

Insurance has been and continues to be a competitive industry. Competition has proven to be a better and more effective regulator of pricing than government in almost any competitive industry in the United States. Careful consideration should be given to the important factor of competition in defending rates used in Texas.

ENDNOTES

¹ Tex. Ins. Code art. 5.13-2

² Garven, James, Dec. 2004, “Enactment of Insurance Reform in Texas Good for Consumers”; <http://rmi.baylor.edu/blog>.

³ Tex. Ins. Code art. 5.144.

⁴ See, Cause No. 03-05-00067-CA; *State Farm Lloyds v. TDI*, where an appeal is pending on the constitutionality of actions by the TDI on a Homeowners rate filing. Similar types of action have been taken by the TDI against Allstate and other insurers.

⁵ Tex. Ins. Code art. 5.144(b-1).

⁶ *Supra*.

⁷ Tex. Ins. Code art. 5.15-1 § 3.

⁸ Tex. Ins. Code art. 5.13-2 § 1.

⁹ See, Leadbetter, D., J. Voll and E. Wieder, 2004, “The Effects of Rate Regulation on the Volatility of Auto Insurance Prices: Evidence from Canada”; <http://economics.ca/2004/papers/0007.pdf>
Harrington, Scott, 2001, “Effects of Prior Approval Rate Regulation of Auto Insurance” AEI-Brookings; (available at <http://aei-brookings.org/admin/authorpdfs/page.php?id=48>);
These articles are also supported by an essay by George J. Stigler entitled, “Economic Theory: Price.” Dr. Stigler’s essay is consistent with his work that won him a Nobel Prize for economics in 1982.
http://www.britannica.com/nobel/macro/5001_98_11.html.

¹⁰ Tex. Ins. Code art. 5.13-2 and art. 1.02.

¹¹ Tex. Ins. Code art. 5.13-2 §3 (5).

¹² The TDI used an 11-12% return on equity to calculate a profit factor in benchmark rates for auto and homeowners. The benchmark was an average statewide rate and individual insurers could still file rates above or below the benchmark using their own profit factors. See, Tex. Ins. Code art. 5.101 (repealed).

¹³ See, *City of El Paso v. PUC, et. al.*, 883 S.W.2d. 179, 187 (Tex. 1993); *SEC v. Chenery*, 332 U.S. 194 (1974).

¹⁴ Any licensee is entitled to know the legal standards before a rate is filed especially where a penalty may be imposed. The elements of meaningful notice and hearing requires previous notice and a hearing relative to the issues of fact and law which will control the result to be reached by the administrative tribunal. *Morgan v. U.S.*, 1, 18-19 (1938); *Madden v. Texas State Bd. of Chiropractic Examiners*, 663 S.W.2d 622 (Tex. Civ. App.—Austin 1983). *Seely, supra.*

¹⁵ Tex. Ins. Code art. 5.13-2 §1(3).

¹⁶ *Merrell Dow Pharms., Inc. v. Havner*, 953 S.W.2d 706, 711 (Tex. 1997).

¹⁷ *Merrell Dow Pharms., Inc. v. Havner*, 953 S.W.2d 706, 713 (Tex. 1997).

¹⁸ *Daubert v. Merrell Dow Pharms., Inc.*, 43 F.3d 1311, 1316 (9th Cir.).

¹⁹ *Daubert*, 509 U.S. at 590, 113 S.Ct. at 2795.

²⁰ *Kelly v. State*, 824 S.W.2d at 572

²¹ *Tex. Mut. Ins. Co. v. Lerma*, 2004 WL 1336229 (Tex.App.-San Antonio 2004, no petn. history).

²² *Id.* at Endnote 9.

²³ Tex. Ins. Code art. 5.13-2 §5(a-1)

²⁴ Tex. Ins. Code art. 5.13-2 § 3(a)(9).

²⁵ 28 Tex. Admin. Code §5.9332.

²⁶ *Supra*.

²⁷ Tex. Ins. Code art. 5.13-2 § 3(a)(9), § 4(a).

²⁸ Tex. Ins. Code art. 5.13-2 §7 (c).

²⁹ Tex. Ins. Code art. 5.13-2 § 7(b). This procedure is questionable from a procedural due process perspective. Important rights can be denied by a disapproval before a hearing is conducted. Among the elements of due process is notice and hearing. *City of Houston v. FORC*, 412 S.W.2d 35, 37 (Tex. 1967).

³⁰ Tex. Govt. Code § 2001.051, et. seq.

³¹ Tex. Govt. Code § 2001.171, et. seq.

³² Tex. Ins. Code art. 5.13-2 § 7 (c).

³³ See Docket No. 454-04-5790.F, *In the Matter of Rates Filed by The Medical Protective Company*.