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2012 INSURANCE REGULATION REPORT CARD

By R.J. Lehmann

Welcome to the inaugural research project of the R Street Institute, a new national public policy research and educational institution dedicated to the mantra: "Free markets. Real solutions."

In keeping with that mission, we will be taking a look each year at the state-based U.S. insurance regulatory system, examining which states are doing the best job of regulating insurance through limited, effective, and efficient government. In this context, that means states should regulate only those market activities where government is best-positioned to act; that they should do so competently and with measurable results; and that their activities lay the minimum possible financial burden on policyholders, companies, and ultimately, taxpayers.

The report card fuses research areas previously examined elsewhere by two of R Street's founding principles: the annual state-by-state property and casualty report cards that R Street President Eli Lehrer has produced for the Heartland Institute, as well as the annual evaluations of state insurance department budgets that R Street Director of Public Affairs R.J. Lehmann has conducted for SNL Financial and the A.M. Best Co.

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There are three fundamental questions this report seeks to answer:

1. How free are consumers to choose the insurance products they want?
2. How free are insurers to provide the insurance products consumers say they want?
3. How effectively are states discharging their duties to monitor insurer solvency, police fraud, and foster competitive, private insurance markets?

Reviewing the data on insurance in 2011, we see continued modest trends toward greater consumer and business freedom in the homeowners and automobile insurance markets, as well as real efforts in some states to scale back, or otherwise place on more sound financial footing, residual insurance markets and state-run insurance entities.

As it rarely does, progress did not come evenly, and certain positive trends were offset by other negative ones. Among the major events in 2011 and early 2012:

- After initially failing to pass significant reforms to the Texas Windstorm Insurance Association during their 2011 regular session, the Texas Legislature reconvened in a special session in June that produced a successful reform package for the state-run wind pool. Responding to the raft of lawsuits over claims-handling procedures following Hurricane Ike, the bill requires claims be filed within one year of an event, streamlines the dispute resolution process, prevents TWIA from writing new policies in certain environmentally sensitive coastal areas, and clarifies that bonds can only be filed once per year. The measure also opens the door for greater territorial rating within the 14 Tier 1 coastal counties that participate in TWIA, an option that TWIA management is currently evaluating. TWIA was placed into receivership in February 2011 amid concerns about conflicts of interest and administrator misconduct. Texas Insurance Commissioner Eleanor Kitzman has hired a consulting group to study ways to restructure the wind pool, having called the program's current structure unsustainable.

- In two consecutive reports, in October 2011 and May 2012, the financial advisor to the Florida Hurricane Catastrophe Fund estimated the state-run reinsurer would not have the financial resources to make good on all of its obligations should Florida be socked with a major hurricane season. The October report pegged the shortfall at $3.2 billion, estimating the Cat Fund would be able to raise up to $8 billion in post-event bonds. By May, the bonding capacity estimate had fallen to $7 billion, $1.8 billion short of the $8.8 billion in bonds that would be needed to meet the fund's mandatory level of $17 billion in exposure. Despite the support of Cat Fund Chief Operating Officer Jack Nicholson for a plan to pare back the fund's exposures gradually, reform legislation stalled in Florida's early 2012 legislative session.

“Citizens was one of several state-run residual market insurance mechanisms to turn to the capital markets to shore up its balance sheet.”

- Little was done to advance depopulation of Florida's Citizens Property Insurance Corp., which has grown to become the largest property insurer in the state, with 1.4 million policyholders. The Legislature passed a measure that reduces the post-event assessments that Citizens can lay on other insurers' policies in coastal zones to 2 percent from the current 6 percent, while eliminating altogether the existing 6 percent regular assessments on other commercial and personal lines policies. A separate bill that would allow Citizens policies to be taken out by surplus lines insurers failed to advance. However, Citizens' management has been exploring ways to speed up depopulation efforts on its own, by paring back coverages, reexamining whether discounts have been properly applied, and reconsidering whether the 10 percent cap on annual rate increases should apply to new policyholders.

- Citizens was one of several state-run residual market insurance mechanisms to turn to the capital markets to shore up its balance sheet. In its first-ever foray into alternative risk transfer, Citizens issued a $750 million catastrophe bond, the largest in history. The successful placement prompted Citizens to up its target for private reinsurance in 2012 from $1 billion to $1.5 billion. Florida Citizens joins Louisiana Citizens Property Insurance Corp., California Earthquake Authority, California State Compensation Insurance Fund, Massachusetts Property Insurance Underwriting Association and the North Carolina Joint Underwriting Association and Insurance Underwriting Association as state-run insurers that have issued cat bonds in the past two years.

- In May 2011, the Tennessee General Assembly passed legislation allowing personal lines insurers to increase or decrease rates by up to 15% without prior approval of the Department of Commerce and Insurance. The change allows insurers to adjust rates within these so-called “flex bands” on an expedited basis, while reserving to state regulators more time to review more significant rate changes.

- In a major victory for the use of credit information as an underwriting tool, the Texas Supreme Court ruled in *Ojo v. Farmers Group Inc.* that state law permits the use of “racially neutral” credit scores in homeowners insurance underwriting and rate-setting. The case was a follow up to a 2010 en banc decision from the U.S. Ninth Circuit Court of Appeals, and found that claims of disparate impact housing discrimination under the federal Fair Housing Act were preempted by the McCarran-Ferguson Act, which reserves insurance regulation to the states. Both Texas and federal law prohibit race-based insurance rating and underwriting.

- New York and Florida both approved laws to modernize regulation of commercial property and casualty insurance. In New York, lawmakers created a new class of commercial lines policies, those whose policies generate between $25,000 and $100,000 in annual premiums, who would eligible under the state's Free Trade Zone for exemptions from certain rate and form regulations. Florida likewise carved out exemptions from the rate filing and approval process for various excess and umbrella, surety and fidelity, machinery, errors and omissions, directors and officers, employment practices, intellectual property, advertising injury and certain commercial property risk coverages.

- The Florida Legislature approved a comprehensive reform package to reform its long-troubled Personal Injury Protection auto insurance system. The bill includes prohibitions on attorneys' contingency fee risk multipliers; codifies insurers' right to conduct examinations under oath; strengthens clinic licensing requirements; eliminates mandatory reimbursements for massage and acupuncture services; and allows insurers 60 additional days to investigate suspected cases of fraud. Unfortunately, the bill also includes new rate restrictions, calling for insurers to provide detailed explanations to justify anything less than a 10 percent rate cut by October 2012 and a 25 percent rate cut by January 2014.

- In May 2011, Minnesota Gov. Mark Dayton signed legislation restricting insurers' ability to contract with rental car providers to offer policyholders temporary replacement rentals while their vehicles are under repair.

- In October 2011, California Gov. Jerry Brown vetoed a trio of bills that would have largely undone workers' compensation reforms spearheaded by then-Gov. Arnold Schwarzenegger and then-Insurance Commissioner John Garamendi in 2003. The measures would have allowed for extension of the 104-week temporary disability cap and required state licensing for physicians and psychologists that do utilization reviews,

- In May 2011, South Carolina Gov. Nikki Haley signed legislation retroactively adding liability provisions to commercial general liability policies to cover defects in work done by contractors.

- Former Illinois Insurance Director Michael McRaith was named by President Barack Obama as the first-ever director of the Federal Insurance Office, a U.S. Treasury Department office created by the Dodd-Frank Act and tasked with monitoring, but not directly regulating, the U.S. insurance industry. A report from the office recommending ways to improve the U.S. insurance regulatory system was due in January 2012, but had not yet been submitted at the time this report went to press.

The study consists of three sections: This introduction, which outlines the purpose of this annual study and a review of major developments of the past year in insurance regulation; an explanation of our methodology; and, finally, the state rankings.

We have chosen this study as the first publication of the R Street Institute because we believe, as a state-regulated business, the insurance market offers a perfect illustration of how differing approaches across what U.S. Supreme Court Justice Louis Brandeis called the 50 different "laboratories of democracy" can result in very different outcomes for consumers, for industry, and for taxpayers. We hope that an objective look at state regulation will encourage states to adopt policies that promote freer markets, more efficient government processes, and a deeper commitment to both consumer choice and consumer protection.

INSURANCE AND GOVERNMENT REGULATION

The insurance market is both the largest and the most significant portion of the financial services industry – and, arguably, the economy as a whole – to be regulated almost entirely at the state level. While state banking and securities regulators have largely been preempted by federal law in recent decades, Congress reserved to the states the duty of overseeing the "business of insurance" as part of 1945's McCarran-Ferguson Act.

On balance, we believe states have done an effective job of encouraging competition and, at least since the broad adoption of risk-based capital requirements, of ensuring solvency. Based on data provided by the Insurance Information Institute, the U.S. auto insurance market had a Herfindahl-Hirschman Index score – a measure of market concentration used by the U.S. Justice Department – of just over 700, while the HHI for the homeowners insurance market is about 720. The DOJ and Federal Trade Commission generally consider markets in which the HHI is between 1,500 and 2,500 points

"On balance, we believe states have done an effective job of encouraging competition and, at least since the broad adoption of risk-based capital requirements, of ensuring solvency."

to be moderately concentrated, while those in excess of 2,500 points are highly concentrated. U.S. personal lines markets are, as a whole and in most particular states, unconcentrated.

Insolvencies are also relatively rare and, through the run-off process and guaranty fund protections enacted in nearly every state, generally quite manageable. According to figures kept by the National Conference of Insurance Guaranty Funds, after accounting for recoveries, the total net cost of the ten largest property and casualty insurance insolvency of the past quarter century is only $5.03 billion, or less than half of the premiums written by the tenth largest property and casualty insurance group in a single year.

"Often driven by political concerns about the price of home or auto insurance, regulators frequently respond to rising rates with restrictions."

However, there are certainly ways in which the thicket of state-by-state regulations lead to inefficiencies, as well as particular state policies that have the effect of discouraging competition and concentrating risk. Central among these, and of particular concern in personal lines property and casualty markets, are rate controls. While explicit price and wage controls have largely fallen by the wayside in most industries outside of natural monopolies such as utilities, rate regulation remains commonplace in insurance.

Some degree of rating and underwriting regulation exists in nearly every one of the 50 states. This is, to a large degree, a relic of an earlier time, when nearly all insurance rates and forms were established collectively by industry-owned rating bureaus, because individual insurers generally were too small and decentralized to be able to collect sufficient data to make actuarial projections. McCarran-Ferguson charged states with reviewing the rates submitted by these bureaus because of concerns – justifiable, at the time – of anticompetitive collusion.

Rating bureaus still exist, but they are now, for the most part, independent consultants. With the notable exception of North Carolina, the bureaus no longer play a central role in most personal lines markets, and many larger insurers now establish rates using their own proprietary formulas, rather than relying on rating bureau recommendations.

While monopolistic practices are no longer a major concern in rate-making and underwriting, there could be a justifiable role for states to exercise rate regulation to ensure that rates are sufficient. Academics who study the property and casualty "cycle" have long noted that, in times of robust investment returns, some insurers tend to underprice their products in an effort to grab market share. These so-called "soft" pricing cycles typically turn harder when nature intervenes and a major catastrophe – such an earthquake, hurricane, or terrorist event – depletes companies' reserves.

But while regulating rates for sufficiency is a justifiable regulatory priority, in practice, it is nearly unheard of for a regulator to reject a rate for being too low. Instead, often driven by political concerns about the price of home or auto insurance, regulators frequently respond to rising rates with restrictions. Sometimes these come in the way of explicit prior approval rules that do not permit insurers to charge the rates they consider necessary. Other times, the restrictions are more subtle, such as disallowing primary insurers' rates to reflect rising reinsurance costs, or dictating which catastrophe modeling software an insurer is permitted to use in assessing its risks. The inevitable result of these attempts at rate suppression is to drive capacity out of state, and to increase pressure on residual market mechanisms to absorb the former policyholders of insurers who have determined that the risk-reward trade-off of continuing to write new business is insufficient.

Generally, residual property insurance markets are of little significance. In all but a few states, these mechanisms serve primarily to take up a handful of policies that the private market will not agree to cover. But in states with excessively stringent controls on rate freedom, such as Florida and Texas, the entities can grow quite large and pose a looming threat to taxpayers. Florida's Citizens Property Insurance Corp. now writes 1.4 million policies and is the largest homeowners' insurer in the state. The Texas Windstorm Insurance Association writes nearly 60 percent of coverage in the 14 coastal counties that participate in the program. In both states, a major hurricane could totally deplete the entities' claims-paying capacity, and it is unclear whether the post-event funding mechanisms the states have created would be sufficient to cover all liabilities.

Historically, state controls not only on rate levels, but also on the ways in which insurers may evaluate and charge for risks, has contributed to suppressing innovation in the personal lines property and casualty insurance market. It has long been a truism of the industry that property and casualty insurers have not introduced a new major product since the introduction of homeowners insurance in the late 1950s.

But where such controls have been loose or non-existent, the industry has shown in recent years that such innovations are, indeed, possible. The pet insurance market, which is written as a personal lines property insurance coverage, has grown at a compounded rate of 18% annually from 2003 through 2008, with 800,000 policies in force and direct written premiums of $272 million in 2008, according to Embrace Pet Insurance. Roughly half-a-dozen auto insurance have introduced various usage-based or "pay-per-mile" insurance programs, with one company's product now permitted in 39 states. Also, insurers have moved to introduced new variations or endorsements to existing policies, such as identity theft protection on homeowners policies or one-time accident forgiveness on auto policies.

We believe such innovations could be more widespread if more states were to free their insurance markets. An open and free insurance market maximizes the effectiveness of competition and best serves consumers.

2. METHODOLOGY

The report card represents our best attempt at an objective evaluation of the regulatory environments in each of the 50 states. It makes use of 14 variables that measure how well states are monitoring insurer solvency and policing fraud, how efficiently they are spending the insurance taxes and fees they collect, how competitive their home and auto insurance markets are, the degree to which they permit insurers to adjust rates and employ rating criteria as they see fit, and finally, the transparency and politicization of insurance regulation in the states. For each of the 14 variables, we use the most recent year's data available.

The report is not intended as a referendum on specific regulators. Scoring a "D" or "F" does not mean that a state's insurance commissioner is inadequate, nor is scoring an "A" an endorsement of those who run the insurance department. For most variables, a plurality of states are assigned a baseline score of zero, earning points for demonstrating they are especially efficient, especially effective, or especially pro-market. Points are detracted for states that demonstrate notable inefficiency, ineffectiveness, or for especially stringent controls on rates and underwriting.

Variables are weighted to provide balance between considering the rules a state adopts and the results it demonstrates, between the effectiveness of regulators in performing their core duties and the efficiency of a state in making use of its resources. The greatest weight is given to variables that matter most to consumers, such as the competitiveness of markets, while giving relatively less weight to matters primarily of interest to companies, such as how politicized or transparent a state's insurance regulatory system is.

Because we are necessarily limited to those factors we can quantify for all 50 states, there are many important considerations that our report card will not reflect. For example, the ability to bring insurance products to market in a relatively timely manner is tremendously important to effective and efficient regulation, but there is little available data on which to compare the states on this score. We also lack good measures of how well states regulate forms, how responsive they are to consumer inquiries, and the level of competition in local markets for insurance agents and brokers.

SOLVENCY REGULATION

There is no single duty more important for insurance regulators than monitoring the solvency of regulated insurers. Alas, the state-based system of solvency regulation has not always been held in particularly high esteem.

Following a spate of liability insurer insolvencies in the late 1980s, then-House Commerce Committee Chairman John Dingell, D-Mich., produced a 1990 report, titled "Failed Promises," that faulted the state regulatory system for failing to provide adequate oversight of insurers' underpricing, inadequate loss reserves, and shaky reinsurance transactions.

Shortly after the release of Dingell's report, the industry was hit again by another spate of insolvencies, this time in the life insurance sector, which was followed by a round of property insurer insolvencies following 1992's Hurricane Andrew. These trends helped give a political boost to legislation sponsored by Dingell in the early 1990s to create a Federal Insurance Solvency Commission and preempt many state regulatory powers.

In response to both the public criticism and the threat of preemption, state regulators moved in 1994 through the National Association of Insurance Commissioners to create and implement a risk-based capital regime of solvency regulation. That regime has held up remarkably well ever since, with few major insolvencies even through such events as the terrorist attacks of September 11, 2001, the record hurricane seasons of 2004 and 2005, and the financial crisis of 2008 and 2009.

As part of our report, we have chosen two variables to monitor how well states are responding to their duty to regulate insurer solvency, both based primarily on data reported by insurance departments in the NAIC's annual Insurance Department Resources Report.

FINANCIAL EXAMS (-5 TO 5 POINTS)

At the heart of the state-based system of insurance regulation is the proposition that, no matter how many states an insurer operates in, primary responsibility for monitoring that insurer's solvency lies with the state in which it is domiciled.

This may strike some as unfair or inequitable. After all, states vary greatly in both size and number of domestic insurers. Indeed, Vermont and North Dakota have very similar populations, but the latter has 38 domestic insurers while the former has 600, most of them small captive insurers. Vermont's total of domestic insurers ranks second only to New York's 639. But while New York is the third largest state, Vermont is the second smallest.

"For most states, insurance regulation is, in effect, a profit center."

However, the burden is not so disproportionate as it would appear. Because insurance departments are funded primarily by fees paid by regulated insurers and insurance producers, those with an unusually high number of domestic companies also reap the windfall of unusually large resources. In fact, as will be discussed in greater detail later in this report, for most states, insurance regulation is, in effect, a profit center.

States conduct two major types of examinations of companies they regulate: financial exams, which look at a company's assets, liabilities, and policyholder surplus, and market conduct exams, which look into a company's business practices and how well it is treating consumers. Sometimes, states conduct joint financial/market conduct exams that look at both sets of factors simultaneously.

States are generally free to subject any company that operates in their market to either type of exam. With financial exams, states overwhelmingly concentrate their attentions on domestic insurers, and it is a regulatory rule of thumb that each domestic company should expect to be examined at least once every five years.

In this report, we attempt to gauge how well states are keeping up with their duties to examine the companies they regulate. We did this by drawing figures on the number of financial exams and combined financial/market conduct exams the states reported completing for domestic companies in each year from 2007 through 2010. We then compared those figures to the number of domestic companies listed as operating in the state for each of those four years, to calculate the proportion of domestic companies that were examined. Given the guidance that every company should be examined at least once every five years, our baseline expectation for the sum of those four years of exams is 80 percent. We found that 33 of the 50 states passed that threshold. For scoring purposes, those who examined between 80 percent and 100 percent of their domestic insurers received as a score of zero. Those who examined more than 100 percent received a score of 3, while the eight states that examined more than 125 percent of their domestic companies received a score of 5. Virginia and New Mexico, with 64 and 23 domestic insurers, respectively, performed nearly twice as many financial exams as they had domestic companies over the past four years.

For states that failed to examine at least 80 percent of their domestic companies, we assigned a score of -3, and the five states that examined less than half of their domestic companies received a -5. Minnesota ranked dead last. That state examined just over 21 percent of its 160 domestic insurers.

RUN-OFFS (-5 TO 5 POINTS)

Measuring financial exams completed offers a good quantitative assessment of how robust a state's solvency regulation regime is, but there is a need for a qualitative assessment, as well. A state could examine every company every year, but if it doesn't actually catch the problems that might lead to insolvency, this would offer little benefit to policyholders.

The best measure we could find to assess the quality of solvency regulation is simply to look to the market of regulatory run-offs, where an insurer has ceased writing new business and instead chosen to wind down its remaining obligations over time. While run-offs are often voluntary, when a company becomes financially impaired, a department may have to intervene by placing the company into receivership. If the company may be saved, a court can order it into a conservatory rehabilitation or supervisory rehabilitation, a reorganization process that can include allowing the company to resume writing new business. Where rehabilitation is deemed not possible, a liquidation order is signed, wherein a company's assets will be sold off to make good on its remaining obligations, and guaranty fund coverage may be triggered to pay claims.

For the report card, we summed the total in-progress claims liability of insurers placed in run-off, supervision, conservation, receivership, and liquidation for each state, as of Dec. 31, 2010. The totals ranged from Pennsylvania's roughly $24.7 billion to ten states that had no in-progress claims liability at all. States were scored on what proportion of their total net written premiums the outstanding run-off liabilities represented.

Those between 0.5 percent and 2.0 percent were assigned 0points. Additional points were granted for those with less than 0.5 percent, ranging up to 5 points for the 10 states with no claims liabilities. Those between 2 percent and 3 percent received -1 points; between 3 percent and 10 percent received -2; between 10 percent and 40 percent received -3; between 40 percent and 80 percent received -4; and Delaware, the only state greater than 80 percent, received -5.

"We downgrade those states where property and casualty insurance is a hot button political issue".

FRAUD (-2 TO 5 POINTS)

Outside of solvency regulation, perhaps the next most important duty of insurance regulators is to police fraud. Particularly in casualty lines of business like auto insurance and workers' compensation, where claims are frequently tied to medical treatment, fraud is a costly problem that can impose significant burdens on consumers and force companies to withdraw from markets.

According to data compiled by the Insurance Research Council, staged automobile accidents and buildup of accident-related treatments added between $4.8 billion and $6.8 billion in excessive payments in 2007. Bogus and abusive claims added another $4.3 billion to $5.8 billion, while insurers lost $15.9 billion due to underwriting application fraud in 2009. The National Insurance Crime Bureau reports that its members referred a record 100,450 questionable claims in 2011, up 19 percent from 2009.

It is exceedingly difficult to assess how well states handle the challenge of policing insurance fraud. However, there is significant variation in the tools and resources that states have granted their insurance departments to tackle the problem, and it is those variations that we have chosen to measure as part of this report card.

- 1 point was assigned to each of the 39 states that maintains a separate criminal fraud unit.

- 1 point was assigned to each of the 32 states where insurance fraud investigators are empowered as officers of the peace.

- 1 point was assigned to each of the 33 states in which there are no limits to the kinds of insurance fraud that can be investigated.

In addition, we looked at the percentage of total full-time equivalent staff and contract workers within each department who are dedicated to antifraud enforcement. States where between 5 percent and 6.5 percent of staff worked on insurance fraud were assigned 0 points. Those between 6.5 percent and 9 percent received 1 point, while those with greater than 9 percent received 2 points. Those with less than 5 percent received -1 point and those with less than 1 percent received -2 points.

Six states – New Jersey, California, Florida, Minnesota, Utah, and New Mexico – received the maximum 5 points for anti-fraud enforcement. Three states – Maine, Michigan, and Wisconsin – received -2.

POLITICIZATION (-10 TO 0 POINTS)

Insurance regulation is a technical matter and should, by and large, be insulated from the political process and prevailing political concerns. It is necessary for insurance regulators to ensure that insurers and insurance producers deal with the public fairly and in good faith. It is necessary to apply risk-based capital rules to ensure insurance companies are responsibly and competently managing both their underwriting and their investment risks. And regulators must be vigilant to stamp out fraud -- whether by carriers, by agents and brokers, or by insureds – wherever it rears its ugly head.

None of these charges are inherently political in nature, and the introduction of political pressure to the process of insurance regulation inevitably leads to negative consequences. Insurance regulators are public servants, and thus it is necessary and valuable for the public to have oversight of their activities. But such oversight is properly exercised through elected governors and legislators, and trained, professional regulators can much more effectively enforce the law unbidden by the shifting winds of political passions.

For this reason, we downgrade those states where property and casualty insurance is a hot button political issue, as well as those where legislation that would restrict insurance market freedom gained traction in 2011 or 2012. Penalties were assessed where:

1. The 11 states in which the insurance commissioner is an elected position automatically received a -4.

2. In states in which property and casualty insurance

regulation was a major campaign topic of at least one statewide election in the past four years, a score of -2 was assigned for each state where that was the case.

3. A -2 was assigned for each bill or comprehensive legislative package that significantly restricts market freedom in property and casualty insurance markets, and that passed at one chamber of the state legislative or passed the insurance committee in both chambers.

> "Of the $18.58 billion states collected from the insurance industry last year, only 6.7 percent was spent on insurance regulation."

REGULATORY CLARITY (-5 TO 5 POINTS)

Rule of law requires that regulations be clear and consistently applied. Neither companies nor consumers can abide by the rules if they cannot anticipate how they will be applied and interpreted. By and large, insurers give state insurance departments good marks on this front, finding most states to be forthright and transparent in their dealings.

However, some states have become notorious for what the industry commonly calls "desk drawer rules," in which regulators interpretation of ambiguities in the statutory code or inconsistent application of legal provisions creates a lack of clarity. Where we received reports from more than one source of a state using "desk drawer rules," we assigned a score of -5. However, we also assigned 5 points to any state that at least two sources identified as being notably transparent in their rule-making and implementation process.

FISCAL EFFICIENCY

We feel it is important that state insurance regulators not only do their jobs well, but that they do them efficiently, with minimal cost to consumers, companies, and taxpayers. Taxes and fees paid to support insurance regulation are passed on as part of the cost of insurance coverage.

States vary in how they allocate funding to their insurance departments. In 23 states, 100 percent of the department's revenues comes from regulatory fees and assessments. Fees and assessments account for more than 90 percent of the budget in eight other states, and for more than 80 percent of the budget in an additional six states. Other states draw on a combination of fees and assessments, fines and penalties, general funds, and other sources. Georgia, Massachusetts, and Pennsylvania are the only states that do not directly draw any of their revenues from the fees and assessments they levy, in each case drawing the bulk of their operating funds from the state's general fund.

Based on the NAIC's 2011 Insurance Department Resources Report, the 50 states, Puerto Rico, and the District of Columbia spent $1.24 billion on insurance regulation in 2010 but collected double that amount, $2.48 billion, in regulatory fees and assessments from the insurance industry. State insurance departments also collected $63.5 million in fines and penalties and another $1.22 billion in miscellaneous revenues. States separately collected $14.82 billion in insurance premium taxes. Altogether, of the $18.58 billion states collected from the insurance industry last year, only 6.7 percent was spent on insurance regulation.

Using this data, we have constructed two variables to measure departments' budget efficiency and the financial burden states place on insurance products.

FEE AND TAX BURDEN (-5 TO 5 POINTS)

First, we look at the total of premium taxes, fees and assessments, and fines and penalties, expressed as a percentage of the premiums written in the state. This is the tax and fee burden, and the results range from a low of 0.06% for Michigan to a high of just under 3% for New Mexico. States with a tax and fee burden of between 1 percent and 1.3 percent were scored zero. Scores then ranged to a low of -5 for states with the highest burden and to a high of 5 points for states with the lowest burden.

REGULATORY SURPLUS (-10 TO 0 POINTS)

As mentioned above, total fees and assessments collected by state insurance departments were double the amount spent on insurance regulation. This figure does not include premium taxes, which are a form of sales tax, thus making it appropriate that they should go into a state general fund. It also does not include fines and penalties, which are meant to discourage bad behavior and to compensate victims of the behavior. Limiting the consideration just to those regulatory fees and assessments that are paid by insurers and insurance producers, states collect more than $1 billion more in regulatory fees than they spend on regulating insurance itself.

That excess amount, which we call "regulatory surplus," is typically diverted to cover other shortfalls in state budgets. Sometimes, these programs have some tangential relationship to insurance, such as fire safety or public health programs, but often, they do not. In essence, by collecting this regulatory surplus from insurance fees, states are laying a stealth tax on insurance consumers to fund what should be general obligations.

For this variable, we assigned 0 points to those states whose fees and assessments were equal to or less than their spending. States with a regulatory surplus of less than 50 percent of their budget received a score of -1. Regulatory surplus of between 50 percent and 100 percent earned -2 points, between 100 percent and 200 percent earned -3 points, between 200 percent and 300 percent earned -4 points, and between 300 percent and 400 percent earned -5 points. Massachusetts, whose regulatory surplus was nearly 10 times the insurance department budget, was assigned -10 points.

"For markets to serve consumers well, there must be a variety of competitors with products designed to fit different budgets and needs."

RESIDUAL AUTO AND HOMEOWNERS' INSURANCE MARKETS (-20 TO 0 POINTS)

Residual automobile and homeowners' insurance markets are intended to serve consumers for whom coverage in the private market cannot be found at a "reasonable" price. In the property and casualty insurance realm, two states (Florida and Louisiana) run full-fledged property insurance companies as state agencies, and two states (North Carolina and Rhode Island) run a semi-private "shared" auto insurance market as reinsurance facilities. All states have residual automobile insurance market laws, although several write either no policies or only a handful of policies.

Except in a handful of cases, residual market pools do not generally have the explicit backing of state government treasuries. However, because no state has ever allowed its residual market to fail, there is typically an implicit assumption that states will stand behind the pool if it encounters catastrophic losses.

Most residual insurance markets are very small. It's unlikely, for example, that a few involuntarily written auto insurance policies representing less than one-half of 1 percent of the market would have serious consequences for automobile insurance prices in any state or affect consumers outside of it.

But where residual markets grow large, it represents evidence that regulatory restrictions have prevented the market from meeting consumers' needs by disallowing what would otherwise be market-clearing prices. Such large residual markets represent a state subsidy for policyholders who take risks the market is unwilling to absorb without higher premiums or some other form of compensation.

We measured the size of residual markets for automobile and homeowners' insurance using data from the Automobile Insurance Plans Service Office and the Property Insurance Plans Service Office, or more recent figures, where they were available.

For each state where the residual market was either nonexistent or represented less than half of 1 percent of the policies in the market, we scored 0. A score of -1 was assigned for states where residual market policies represent between 0.5 and 1 percent of the market. Further points were subtracted, up to a maximum of -10, for states whose residual markets represented larger slices of the overall market. Only five states saw more than one point deducted for the size of their residual auto markets and only seven states saw more than one point deducted for the size of their residual homeowners markets.

MARKET CONCENTRATION (-10 TO 10 POINTS)

"Free" markets are a theoretical abstraction. Competitive markets are a measurable reality.

For markets to serve consumers well, there must be a variety of competitors with products designed to fit different budgets and needs. A high degree of market concentration is not necessarily a sign that consumers are poorly served, but it can be an indication of unnecessarily high barriers to entry or other market dysfunction.

Using data supplied by SNL Financial, we calculated the concentration of each state's auto and homeowners insurance markets, as measured by the the Herfindahl-Hirschman Index. The HHI, which is used by the Department of Justice and Federal Trade Commission to assess the degree to which markets are subject to monopolistic concentration, is calculated by summing the squares of the market share totals of every firm in the market. In a market with 100 firms, each with 1 percent share, the HHI would be 100. In a firm with just one monopolistic firm, the HHI would be 10,000.

The DOJ and Federal Trade generally consider markets in which the HHI is between 1,500 and 2,500 points to be moderately concentrated, while those in excess of 2,500 points are highly concentrated. By those metrics, no state's home or auto insurance markets are highly concentrated, while just two auto insurance markets and three home insurance markets rate as moderately concentrated.

"Ultimately, it is not possible to force an insurer to sell coverage at levels below what they deem to be acceptable risk-adjusted returns."

For the report card, we gave -5 points to each market that fell into the moderately concentrated category, with an HHI of greater than 1,500. Those that were approached that concentration threshold, with HHI scores of between 1,250 and 1,500, had -3 points deducted. Conversely, we gave 5 points to the seven states with auto insurance HHI scores of less than 750 and the eight states with home insurance HHI scores of less than 750. Those between 750 and 1,000 received 3 points, while those between 1,000 and 1,250 were assigned 0 points.

RATE REGULATION (-20 TO 20 POINTS)

We should admit our biases upfront: when it comes to prices, we believe markets regulate themselves. States impose a variety of schemes to impose controls on how quickly or how sharply premium rates can rise, but ultimately, it is not possible to force an insurer to sell coverage at levels below what they deem to be acceptable risk-adjusted returns.

Leaving the futility of rate controls to the side, it is important to note that not all rate regulation systems are created equal. Based on a synthesis of both statutory rules compiled by the NAIC, and analysis of how certain states apply the rules on the books, we have classified rate regulation systems into six categories, from most to least restrictive and distortionary.

State-Made Rates: (-20 points) Just one state, Florida, is classified as practicing "state-made rates." The reason for this is that rates set by state-run Citizens Property Insurance Corp., which were rolled back and frozen in 2007 and have been permitted to rise just 10% annually since 2010, effectively act as the ceiling on rates that private insurers can charge. Citizens is required by law to accept any applicant who can produce a quote from even one insurer who charges at least 15 percent more for a similar policy.

Low Flexibility: (-10 points) Most of the states falling into the low flexibility category have prior approval rating systems, in which the regulator must explicitly approve each rate or rating change before an insurer is permitted to deploy it in the market. In theory, Texas has a "file and use" law, but insurers report that filings prove so burdensome that it functions similarly to a prior approval system.

Below Average Flexibility: (-5 points) States with more flexible prior approval systems or with relatively inflexible file and use systems were categorized as below average. States fall into this category have rules for rate changes that are relatively transparent and predictable, but nonetheless, unnecessarily stringent. No state with a prior approval system for property and casualty insurance scored better than this category's -5 points.

Moderate Flexibility: (0 points) The baseline rating of 0 points was reserved for states that maintain conventionally administered file and use and flex rating systems. These systems generally allow the market to set rates, but reserves additional scrutiny for larger rate changes. With the passage of its flex rating law in 2011, Tennessee moved from below average to moderate flexibility.

Above Average Flexibility: (5 points) Roughly a dozen states maintain use and file or file and use systems that are only lightly administered. Insurance commissioner retain the authority to disapprove rates or delay their implementation, but typically only exercise that authority in particularly extreme cases.

High Flexibility: (10 points) A handful of states have use and file systems where interventions to disallow a filed rate is limited to cases either where the rating system may have a discriminatory impact, or where it is likely to prove inadequate and endanger the company's solvency. These states were judged to have high flexibility and received 10 points.

No File: (20 points) The state of Illinois is unique in which insurers generally do not have to file rates at all, although they must keep documentation of their rates available for regulators to review. This system's nearly pure free market in insurance rates was awarded with 20 points.

CREDIT SCORING (-5 TO 0 POINTS)

The evolution of credit-based insurance scoring has arguably been the biggest factor in massive depopulation of state residual auto insurance markets. In the past, auto insurers had only a limited number of rating factors on which to base their underwriting and rate-setting decisions, and only a limited number of consumers could qualify for preferred standard rates. The discovery of actuarially credible variables tied to credit information has allowed insurers to construct tremendously innovative proprietary rating models that can assign a proper rate to virtually any potential insured.

However, the use of credit in insurance has periodically proven to be politically controversial. Despite studies by, among others, the Federal Trade Commission and the Texas Department of Insurance demonstrating conclusively that credit factors are predictive of future claims, some politicians and much of the general public have remained skeptical.

Responding to concerns about the disparate impact credit-based insurance scoring could have on certain protected populations, 26 states have passed a model regulation promulgated by the National Conference of Insurance Legislators that bars insurers from using credit scores as the sole factor in determining insurance rates. While reasonable and well-meaning, such regulations are also largely irrelevant, as no insurers uses credit scores as their only underwriting variable.

However, a few states have moved beyond the NCOIL model to explicitly ban credit scoring in personal insurance California, Hawaii and Massachusetts all have banned the use of credit in auto insurance underwriting and rate-making, while Maryland has banned its use in homeowner's insurance. Michigan also passed legislation banning credit scoring in personal lines insurance, but that bill was later struck down by the Michigan Supreme Court.

We deducted -5 points for each of the four states with active credit scoring bans.

TERRITORIAL RATING (-5 TO 0 POINTS)

Where a piece of property is located, or where a car is garaged and driven, can have a large impact on the likelihood that it will experience claims-generating losses. States generally recognize this reality, and permit insurers to consider location as a factor in their underwriting and rate-setting decisions.

Like the use of credit, most states generally prohibit insurers from making territory the sole factor in determining whether and at what price to insurance cars and homes. However, in some states, regulators enforce restrictions on the use of territory that are much more stringent than the norm. For those states, we have deducted -5 points.

3. GRADING AND RESULTS

We calculated scores for every state by adding all variables and calculating a standard deviation from the mean. (The mean was -1.82.) States were graded as follows:

More than two standard deviations above the mean: A+

More than one standard deviation above the mean: A

Above the mean by less than one standard deviation: B range

Below the mean by less than one standard deviation: C range

Below the mean by more than one standard deviation but less than two standard deviations: D range

Below the mean by more than two standard deviations: F

We awarded pluses and minuses to recognize states at the top and bottom end of each grade range.

Vermont had the best property and casualty insurance regulatory environments in the U.S. this year, rating more than two standard deviations above the mean. It scored 28 out of a maximum possible score of 55. It was deducted a few points for the relative size of its regulatory surplus, its lack of antifraud enforcement, and for having a modestly sized residual auto insurance market.

Only one state, Florida, received a failing grade, falling more than two standard deviations below the mean. Nonetheless, even Florida had its strong points, including extensive antifraud enforcement, a low tax and fee burden, and a homeowners insurance market that is not very concentrated.

In conclusion, we are hopeful that R Street inaugural insurance regulation report card proves helpful and informative for consumers, lawmakers, regulators, the insurance industry, and the general public. We welcome comments and constructive criticism as look forward to steadily improve the report in the years ahead.

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STATE RANKINGS

STATE	Letter Grade	Total Points	Financial Exams	Run-offs	Fraud	Politici-zation	Regulatory Clarity	Tax Burden	Regulatory Surplus	Auto Market Share	Home Market Share	Residual Auto	Residual Home	Rate Controls	Credit Scores	Territorial Rating
Alabama	C	-6	-3	2	-1	-2	0	-2	-1	0	-3	0	-1	5	0	0
Alaska	C	-7	5	5	4	0	0	-4	-2	-5	-5	0	0	-5	0	0
Arizona	B	4	-5	2	3	0	0	-3	-1	5	3	0	0	0	0	0
Arkansas	C	-8	-3	1	4	0	0	-3	-2	0	0	0	0	-5	0	0
California	D	-19	5	-2	5	-10	-5	3	-1	3	0	-1	-1	-5	-5	-5
Colorado	C+	-3	0	3	4	0	0	3	0	3	0	0	-1	-10	0	-5
Connecticut	C	-4	0	-1	1	0	-5	4	-1	3	5	0	0	-5	0	-5
Delaware	C-	-9	5	-5	0	-6	0	-2	0	0	0	-1	0	0	0	0
Florida	F	-32	-3	-1	5	-6	0	4	0	0	5	-1	-10	-20	0	-5
Georgia	C	-6	0	5	3	-4	-5	2	-3	0	-3	0	-1	0	0	0
Hawaii	D+	-17	-3	0	4	0	0	-1	0	0	-5	-1	-1	-5	-5	0
Idaho	A	11	3	1	3	0	0	0	-1	3	3	0	-1	0	0	0
Illinois	A	21	0	0	-1	0	5	3	-1	0	-5	0	0	20	0	0
Indiana	B-	1	0	-4	-1	0	0	3	0	3	0	0	0	0	0	0
Iowa	C	-5	-5	5	2	0	-5	3	-3	3	0	0	0	-5	0	0
Kansas	C	-5	3	2	1	-4	0	1	-1	3	0	0	0	-10	0	0
Kentucky	B-	0	-3	1	4	0	0	-2	-2	0	-3	0	0	5	0	0
Louisiana	D+	-14	0	0	2	-4	5	-4	-4	-5	-3	0	-6	5	0	0
Maine	A	10	-3	5	-2	-2	0	-3	0	5	5	0	0	5	0	0
Maryland	B	2	3	5	4	-4	0	0	0	-3	0	-3	0	10	-5	-5
Massachusetts	D	-23	0	0	3	-6	0	0	-10	-3	5	-4	-8	5	-5	0
Michigan	C-	-12	3	2	-2	-4	-5	5	0	0	0	0	-1	-10	0	0
Minnesota	B-	-1	-5	5	5	-2	0	0	-2	3	0	0	0	-5	0	0
Mississippi	B-	-1	3	-1	2	-4	0	-4	-2	5	-3	0	-2	5	0	0
Missouri	B	4	0	0	1	0	0	2	-1	0	-3	0	0	10	0	-5
Montana	C-	-10	-3	1	2	-4	0	-4	-5	3	0	0	0	0	0	0
Nebraska	A	10	3	0	2	0	0	1	-1	3	-3	0	0	5	0	0
Nevada	C+	-3	-3	3	3	0	0	-4	-2	5	0	0	0	-5	0	0
New Hampshire	B	2	0	-4	3	0	0	-1	-1	5	5	0	0	0	0	-5
New Jersey	B+	5	0	-1	5	0	-5	2	-3	3	5	0	-1	-5	0	5
New Mexico	C+	-2	5	3	5	0	0	-5	-5	3	-3	0	0	-5	0	0
New York	D	-25	-3	-2	3	0	-5	-1	-5	-3	3	-1	-1	-10	0	0
North Carolina	C	-4	3	0	3	-4	5	-1	-1	3	3	-10	0	-5	0	0
North Dakota	B+	7	0	5	1	-4	0	0	-1	3	3	0	0	0	0	0
Ohio	A	19	0	-2	2	0	5	1	-2	3	3	0	-1	10	0	0
Oklahoma	C+	-3	5	-1	3	-4	0	-1	-3	3	0	0	0	0	0	-5
Oregon	B+	5	3	4	0	0	0	4	-1	3	-3	0	0	0	0	-5
Pennsylvania	C-	-11	3	-3	1	0	-5	1	-3	0	0	0	0	-5	0	0
Rhode Island	C	-5	-3	-2	1	0	0	-2	0	3	5	-3	-4	0	0	0
South Carolina	B	2	-5	1	1	-2	5	2	-2	0	0	0	-3	5	0	0
South Dakota	B+	7	0	5	3	0	0	-3	-4	3	3	0	0	0	0	-5
Tennessee	C+	-3	5	0	1	0	0	-5	0	0	-3	-1	0	0	0	0
Texas	D	-21	3	-1	2	0	-5	-2	-2	3	0	-2	-7	-10	0	0
Utah	B+	9	-5	1	5	0	0	0	0	3	0	0	0	5	0	0
Vermont	A+	28	0	2	-1	0	5	5	-2	5	5	-1	0	10	0	0
Virginia	A	10	5	-2	0	0	5	0	-3	0	0	0	0	5	0	0
Washington	C	-7	5	2	3	-6	-5	-3	-1	5	3	0	0	-10	0	0
West Virginia	C+	-3	-3	5	4	0	0	-4	-4	-3	-3	0	0	5	0	0
Wisconsin	B	4	-3	-2	-2	0	0	3	-3	3	3	0	0	5	0	0
Wyoming	A	17	3	5	-1	0	0	3	0	0	-3	0	0	10	0	0

Mean = -1.82

Standard deviation = 11.7137