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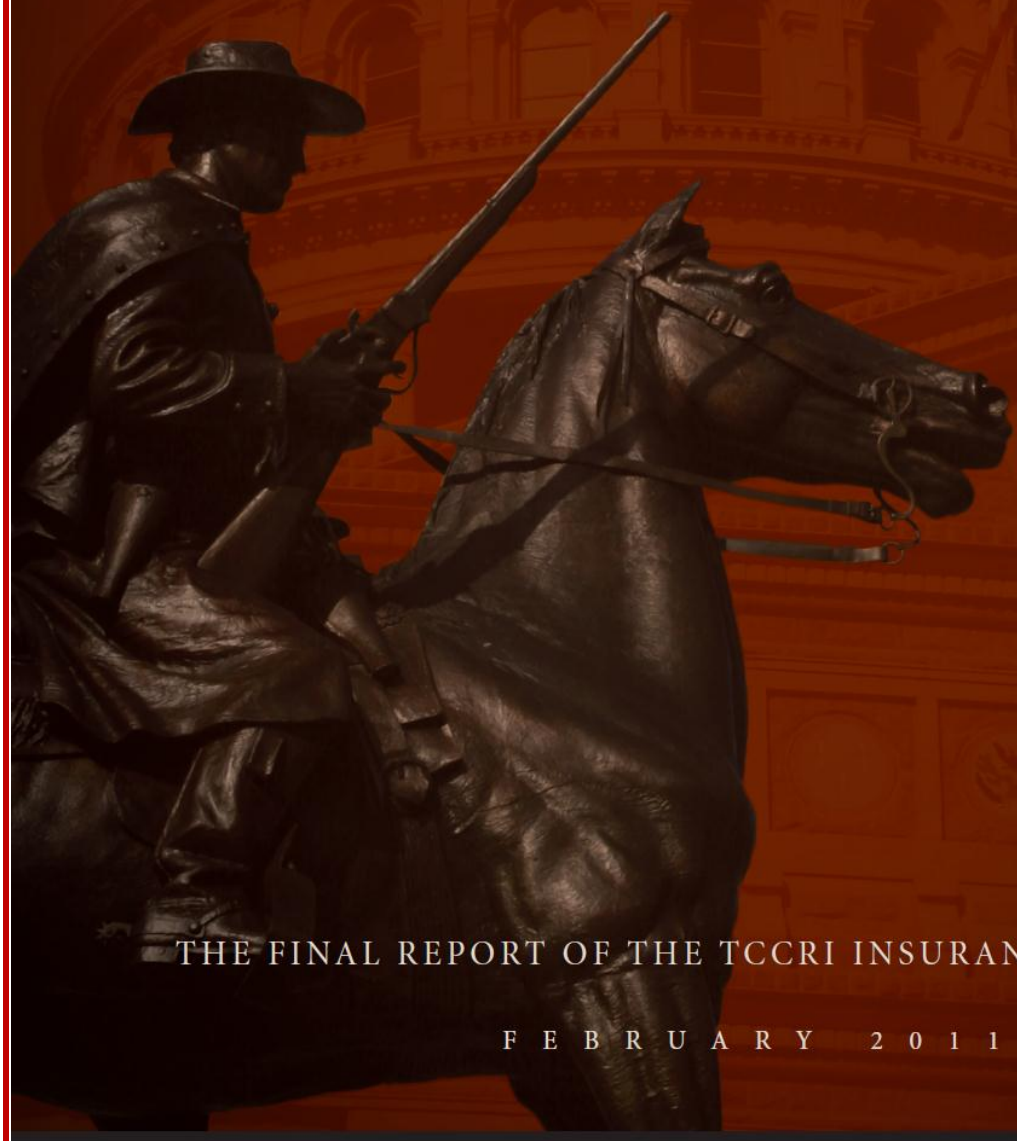

The Final Report of the TCCRI Insurance Task Force

February 2011

The Texas Conservative Coalition Research Institute | txccri.org

INSURANCE TASK FORCE
FINAL REPORT

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ABOUT TCCRI TASK FORCES

The Texas Conservative Coalition Research Institute's Task Forces are the backbone of the Institute's research and education efforts. Based on the conservative principles of limited government, individual liberties, free enterprise, and traditional values, the Institute's Task Forces develop legislative leaders and sound public policy ideas by bringing together legislators, experts, industry leaders, and stakeholders in a unique forum that fosters discussion and debate among public and private sector leaders. This approach has proven to be very successful.

LETTING THE MARKET WORK:

FINAL REPORT OF THE TCCRI INSURANCE TASK FORCE

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1. Introduction

The Legislature created the Texas Department of Insurance's (TDI) original predecessor, the Department of Insurance, Statistics and History, in 1876. Today, TDI regulates the Texas insurance industry to ensure that Texans have access to fair and competitive insurance products. To accomplish this, TDI: regulates insurance companies' solvency, rates, forms, and market conduct; licenses individuals and entities involved in providing insurance products; provides consumer education and resolves complaints; takes enforcement actions against those who violate law or rule and investigates those who engage in insurance fraud; and provides statewide fire prevention services through the State Fire Marshal's Office.

The federal government delegated insurance regulation to the states through the 1945 *McCarran-Ferguson Act*. Current federal regulation is minimal, making it critical for the State to continue to protect consumers by making the Texas insurance market the most competitive in the nation. Texas has consistently been a national leader in limiting government and promoting market forces to increase investment and growth in the state. However in the area of insurance regulation, recent regulatory activity threatens free-market reforms.

Encouraging competition through sensible laws and administrative rules in Texas is especially critical given the size of the market in the state. Insurers collect over $100 billion in insurance premiums from Texas consumers every year and licensed over 1,800 insurance companies in 2009.[i] In return, insurance companies assume risk and cover policyholders' expenses for unforeseen events. Many different insurance products are available, some of which are required by law. For example, state law requires Texas drivers to maintain a minimum level of automobile insurance. To purchase a home, consumers are required to purchase homeowners and title insurance. Although it will be mandatory by 2014 per the Patient Protection and Affordable Care Act of 2010 (pending ongoing legal challenges), the majority of Texans choose to maintain health insurance either through their employer or on their own. Many other lines of insurance exist, such as accident, life, and annuity that provide additional protection for consumers in the event of emergencies.

2. Property and Casualty Insurance

2a. A Tipping Point in the Insurance Market

The Texas insurance market reached a crisis point earlier this decade when several factors converged, namely rising homeowners' insurance premiums and a huge spike in mold claims. From the first quarter of 2000 to the fourth quarter of 2001, the total number of mold claims grew from 1,050 to 14,706.[ii] While premiums also rose during this time, they could not keep pace with the skyrocketing claims. In both 2001 and 2002, insurers paid out more in claims than they collected in premiums.[iii]

Earlier reforms passed in 1997 allowed TDI to permit insurers to use national forms instead of state-mandated forms. However TDI was slow to implement this reform, and was unable to mitigate the losses of the increasing mold claims. Consequently, the rising premiums cost Texans hundreds of millions of dollars and over thirty companies writing homeowners insurance left the market.[iv]

Coverage changes for most companies were made in 2002, helping to bring mold claims back down and stabilize rates. The use of non-standard forms was also fully implemented by TDI, helping to further settle the insurance market. However, the damage was done, resulting in some companies being forced to spend millions on refunds, rate reductions and restitutions. This experience serves as a useful example of the limitations—and ultimately failures—of improper government regulation.

On the heels of this crisis, the Legislature passed Senate Bill 14 (78R) in 2003, which implemented a range of reforms to the Texas insurance marketplace. Most notable among these reforms was the replacement of the "flex-band" system of residential property and auto rate regulation with a new "file-and-use system". Under the old "flex-band" system, insurance companies could set rates without regulatory oversight only within a pre-determined range of a "benchmark" set annually by TDI. The new "file-and-use" system permitted insurers to use rates after they have been filed with TDI without awaiting approval, provided that the rates are based on sound actuarial principles and are non-discriminatory.[v] Both insurers that had been subject to state-set benchmark rates as well as insurers that previously were not rate regulated were brought under this unified rate regulation. There was a transition period until September 2004 during which personal property insurance rates were subject to prior approval and then rates became subject to the file-and-use regulation.

2b. Current Property and Casualty Rate Regulation

Although the new file-and-use system for property and casualty insurance is operational, its full implementation is not complete. In its final report on TDI, the Sunset Commission notes that "the Legislature cannot judge the success of the shift to file-and-use rate regulation because the system has not been fully implemented."[vi] One reason for the incomplete implementation is the continued use of pre-market and post-market regulatory tools which allow TDI to reject rates both before and after being used in the marketplace.

TDI is permitted to review rates that have been filed and can disapprove rates if they do not meet statutory standards, which include those that are excessive, inadequate, or unfairly discriminatory. An insurer is entitled to a hearing and judicial review. If TDI determines an insurer's rates require supervision due to financial condition or rating practices, or if there is a statewide insurance emergency,

the Department can place the insurer under prior approval. The insurer is also entitled to a hearing and judicial review in this situation.

The new system has been a significant shift away from the cumbersome benchmark rate and flex-band system for rate-regulated insurers and brought many formerly unregulated insurers, such as Lloyd's and County Mutual companies, under TDI regulation. These reforms are intended to ensure availability and price competition and to prohibit price fixing and other non-competitive behaviors, allowing Texas to benefit from the competitive market systems observed in other states.

TDI also requires insurance companies to provide consumers with a Consumer Bill of Rights whenever they issue a policy. This document explains the rights of consumers in the insurance market and provides guidance on how to obtain more information about insurance companies, the insurance market, and other information that must be provided for policy-owners.[vii] The Consumer Bill of Rights reduces the need for direct state regulation of the insurance industry or insurance rates: If consumers have ready access to information concerning prices (premium rates) and the insurance market, competition between insurance companies will increase, which will drive prices down and negate the state's regulatory role.

2c. The Benefits of Competition

More competition in the insurance market benefits Texas consumers: Attracting a greater number of insurers to do business in Texas both increases the availability of coverage and leads to lower premiums through a broader choice of products.

Several other states provide instructive examples of opportunities to increase competition among insurance providers while also providing more coverage options and lower premiums to consumers.

- **Massachusetts:** The auto insurance market in Massachusetts shows how price competition delivers lower rates for consumers. In May 2008, an editorial in *The Wall Street Journal* noted that "for three decades. . .because there was no price competition, some of the biggest insurers wouldn't do business in the state." However, in 2008:

  > The state government decided to try a little experiment in the free market…this modest experiment in price competition is already working to reduce costs for consumers. Progressive, the third-largest insurer in the country, entered the market May 1 with rates that are on average 18 percent below the old price-controlled rates. Overall, premiums in the state are due to fall nearly 8 percent this year as insurers adjust to a world in which they need to compete to attract customers instead of bargaining with their regulator for price hikes. Imagine: When you remove price controls, supply increases and prices fall.[viii]

- **South Carolina:** Insurance market reform done earlier this decade in South Carolina is also instructive. Under the state's Motor Vehicle Financial Responsibility Act of 1997, insurance companies were given more latitude to set premium rates without having to gain approval from the state's Department of Insurance. Other reforms were also undertaken to decrease both regulation and rate subsidization in order to foster competition and expand the number of insurance companies operating in the state.[ix]

Average auto insurance rates in South Carolina fell from $718 to $617 between 1998 and 2001 as a result of the market reforms.[x] The 74 companies offering auto insurance in South Carolina in 1996 more than doubled to 156 companies by 2000. As a result of price competition and market expansion, the National Conference of State Legislatures noted that "[w]hile auto insurance costs rose an average of 4.57 percent nationwide, expenses in South Carolina decreased."[xi]

- **Illinois:** Regulation of insurance rates in Illinois is unique. In 1969, in line with the general movement in progressive states toward competitive rating systems, the state legislature enacted an open competition law that became effective January 1, 1970, replacing the prior approval law. This legislation included a sunset clause that caused the open competition rate regulatory law to expire in August 1971.

  The intent apparently was either to renew the rate regulatory law or to revise this legislation after a brief experiment. However, a stalemate in the state legislature prevented either proposal from being enacted, so the rate regulatory law in Illinois expired and was not replaced. Thus, Illinois became the only state in the country without a rate regulatory law.[xii]

  The success of the competitive system has dissuaded the state legislature from enacting any rate regulatory law, so Illinois continues to operate in a completely open and competitive environment for most lines of business, including auto insurance.

  The Illinois experience underscores that rate regulation for insurance is unnecessary in a competitive marketplace. Illinois has functioned without a rating law since 1971. Auto insurance is widely available from a large number of competitors. Rate changes are frequent, modest, and appear to follow claim experience. Loss ratios and the size of the uninsured and residual market, as well as insolvency assessments, are in line with that in states that have competitive rating laws. Thirty years of experience proves that the insurance market functions effectively without any rate regulation.[xiii]

2d. Building on the 2003 Reforms

Despite an incomplete transition to a true file-and-use system, the evidence shows that Texas' homeowners insurance market is far more competitive today than it was before the SB 14 reforms were passed in 2003. Between 1997 and 2003, the number of companies writing homeowner insurance in Texas declined from 166 to 101. By 2008, there were 29 new companies writing homeowners insurance, and there was a significantly higher level of competition in the market.[xiv] Furthermore, companies began offering many different policy options for coverage, deductibles and exclusions, and Texans were no longer required to purchase the "one size fits all" state-promulgated policy form.

In March 2004, TDI reported that "[a]fter back-to-back years of massive instability, the Texas homeowners' insurance market has turned the corner and is regaining momentum to be more competitive."[xv] Then-Insurance Commissioner Jose Montemayor lauded the efforts of the 78th Legislature, pointing out in 2004 that "[t]his return to competitiveness is due to the reforms of Senate Bill 14, passed by the 78th Legislature in 2003."[xvi]

The Dallas Morning News commented that:

> Except for along the hurricane-prone coast, the residential insurance market in Texas is the most stable, profitable and competitive it has been in years. The main reason is that lawmakers in 2003 gave insurers greater flexibility to compete for customers. Homeowners' rates have dropped 6 percent in the past five years, even as home values and replacement costs have climbed dramatically. At least 29 new companies have begun writing home insurance policies in Texas. Average premiums statewide also are lower, a trend that probably will continue if lawmakers don't yield to election-year impulses.[xvii]

As the table below shows, the reforms enacted in 2003 have allowed homeowners to benefit from lower insurance rates even as property values have continued to increase:

TEXAS HOMEOWNERS INSURANCE RATES 2002-2009

Year	Average Written Amount of Insurance per Policy	Average Premium Cost per Policy	Average Written Premium per $1,000 of Insurance
2002	$142,400	$1,232	$8.64
2003	$151,400	$1,249	$8.37
2004	$161,100	$1,244	$8.37
2005	$169,000	$1,222	$7.26
2006	$181,100	$1,215	$6.79
2007	$196,100	$1,251	$6.37
2008	$201,200	$1,272	$6.32
2009	$208,300	$1,332	$6.39

Source: Texas Department of Insurance

Despite these improvements, there are still some problems with the regulation of insurance rates that the 82nd Legislature should address.

2e. Clarity in the Prior Approval Process

Even under the new system, TDI has the authority to place individual insurers under prior approval and is not required to tell insurers what is required for the insurer to return to the file and use regulatory system.

Since the new system has been in place, only two insurers have been placed under prior approval. However, these two insurers provide coverage for 45 percent of the market for homeowners insurance. This has resulted in a situation in which "a large portion of the market [is] operating under a different system of regulation."[xviii]

While recognizing that the prior approval process is an important tool in protecting consumers from excessive rates, the Sunset Advisory Commission noted that "TDI has not defined the factors that contribute to a company being place under prior approval, nor the factors that lead to a company getting out from under [it], which can create uncertainly about regulation for insurers."

Regulatory certainty is imperative if Texas is to maintain a vibrant and competitive insurance market. At minimum, this demands reforms that limit the circumstances in which insurers can be placed under prior approval.

Recommendation

- *Ensure that the Insurance Commissioner can place under prior approval only those companies whose financial positions warrant increased supervision in order to maintain solvency.*

2f. Strengthening Competition through Reasonable Regulation

Legislators should support the continued transition to a competitive insurance market by retaining and strengthening reforms enacted since 2003. Effective competition relies on minimal and appropriate regulation by the State. The mission of the Texas Department of Insurance is to "protect insurance consumers by regulating the insurance industry fairly and diligently [and] promoting a stable and competitive market."[xix] This can be achieved by allowing free price competition while also monitoring the solvency and market practice of insurance companies.

Monitoring market practice is important so that all companies are competing on a level playing-field. The National Association of Mutual Insurance Companies (NAMIC) suggests the parameters for appropriate regulation of market practice:

> [A] market surveillance program must be adopted by the states operating under the premise that most insurance companies are in business to treat their policyholders fairly and only companies that violate that trust should be pursued and punished.[xx]

Similarly, regulating for solvency helps ensure that the insurance marketplace functions effectively to mitigate risk. The ultimate goal of solvency regulation is to avoid situations in which insurers are unable to pay legitimate claims, which undermines the essential function of the insurance market.

As NAMIC notes:

> The core focus of state insurance regulation is solvency monitoring, and state regulators have an array of tools to be used for this monitoring on either a periodic basis or special basis to help insure a financially sound insurance market.[xxi]

Sensible regulation of solvency and market practice in the insurance marketplace will provide consumers with the necessary protections that will enable the free market to work. Competition between insurance providers coupled with reasonable regulation of those providers will continue to make insurance more available and affordable for all Texans.

Since 2003, TDI has disapproved only five of 415 rate filings. However, these disapprovals affected 45 percent of the homeowners' insurance market. In rejecting these rates, TDI regulated a large portion of the market instead of allowing the market to regulate itself through competition. These actions had a negative effect on the marketplace and created regulatory uncertainty. It has also left the

impression that consumers must wait for government action before beginning to shop for better insurance rates in the market.

The Legislature should more clearly define the grounds on which a rate can be disapproved. As noted above, Section 2251.052(a)(7) of the Insurance Code allows an insurer to set a premium rate that will deliver a "reasonable margin for profit." In determining whether an insurer has met this criteria, TDI must consider the effect that a catastrophic event would have on the profitability (and ultimately the solvency) of an insurance provider in the long term. The Texas Coalition for Affordable Insurance Solutions (TCAIS) points out that:

> To be prepared for extraordinary events, insurers spread risk over a large number of people as well as over time. **Insurance profitability is properly viewed over a period of several years, not a single year's performance…It took insurers 11 years (1993-2003) to erase the underwriting loss associated with Hurricane Andrew. The four hurricanes of 2004 erased the prior seven years of profits**.[xxii]

Texas experiences some of the most severe weather in the nation, and the regulatory structure of the state's insurance industry must reflect this fact so that insurers can build sufficient resources in good years to pay consumers' claims in bad years.

In 2008, TDI noted that:

> Most insurers do not file and use rates immediately, as allowed under State law. Despite the shift to file-and-use, TDI reviews the majority of rates before their use, which may create uncertainty for insurers about when they can implement rates. Both TDI and insurers indicate that some companies voluntarily delay using rates pending some indication from the Department that the filing review is complete.[xxiii]

Voicing similar concerns, TCAIS argues that:

> With a true file and use system, insurance companies would have the ability to set their own rates, [which] will lead to lower rates for consumers because companies will compete to attract new customers… Because of a law passed in 2003, insurance companies have more flexibility in setting their rates for home and auto insurance in Texas. Unfortunately continued government regulation of Texas insurance through discretionary authority exercised by the insurance commissioner has resulted in continued, unnecessary market uncertainty. The fully implemented file and use system will result in a more competitive marketplace and more insurance companies from which consumers can choose.[xxiv]

The Legislature must promote efforts to reduce the regulatory uncertainty that currently exists in the insurance market. Insurers must be able to set rates based on conditions in the competitive market. The state need only regulate insurers for solvency, market practice, and fraud. Rate regulation is not necessary in a competitive market so long at these three factors are adequately scrutinized by the state. Just as the state does not regulate the prices of goods that could be termed "necessities," such as food, clothing, or water, there is no reason to regulate insurance rates. Indeed, even as the price of regular grade gasoline in Texas rose close to $4 per gallon in June 2008, a *120 percent price increase* from $1.40 per gallon just five years earlier[xxv], the state did not step in to regulate prices despite the impact that such a cost increase has on businesses and families.

The fundamental problem with regulating prices is that government regulation ignores what prices mean and why they are important. In his book "Basic Economics," Dr. Thomas Sowell puts it thusly: "Prices play a crucial role in determining how much of each resource gets used where. Yet this role is seldom understood by the public and it is often disregarded by politicians."[xxvi]

And in a competitive insurance market, prices are another factor upon which insurance carriers are able to compete for customers. As long as the state continues to exert any regulatory authority over prices, the competitiveness of the marketplace will be compromised, to the detriment of homeowners, businesses, and other customers.

Debates on insurance regulation rest on fundamental principles: Texas' experience and the experience of other states have shown that deregulation and competition deliver choice and lower costs for consumers.

Recommendations:

- *Support the continued transition to a competitive insurance market. Property and casualty insurers need only be regulated for solvency, market practice, and fraud.*

- *Clarify and increase transparency in the rate regulation process. Limit the supplemental information insurers may be required to submit to TDI and limit the amount of time the Department has to review rate filings to 30 days.*

- *Amend TDI's mission so that the agency is charged with "protecting consumers by encouraging an open marketplace through competitive pricing, and diligently monitoring for fraud and solvency."*

2g. Eliminating Funding Diversions

The Texas Insurance Code (Chapter 271) provides that proceeds from the state's insurance maintenance fees (which are assessed on the total value of premiums reported by an insurer operating in Texas) must be deposited in the general revenue fund and reallocated to the Texas Department of Insurance operating account:

> § 271.010. DEPOSIT OF MAINTENANCE FEES. (a) The comptroller shall deposit maintenance fees collected under this chapter in the general revenue fund to be reallocated to the Texas Department of Insurance operating account.

The Insurance Code also provides that the commissioner must annually set the maintenance fee rate so that it produces the amount necessary to pay the expenses of regulating insurance. In recent years, significant portions of the maintenance fee have been spent on programs outside the Department of Insurance. In its Sunset Commission hearing material, TDI noted that:

> [S]everal other state programs, related to regulating insurance but housed at agencies other than TDI, receive appropriated funds that are collected from maintenance taxes. For example, in 2007, the Legislature appropriated about $3.6 million in maintenance taxes to the Texas Cancer Council.[xxvii]

Allowing dedicated funds to be spent in other areas of the budget or to accrue in accounts in the state treasury creates tremendous opportunities for unchecked and wasteful spending that allows an agency or program to deviate from its core mission, and underfunds an agency to which the revenue should be directed.[xxviii] Therefore, dedicated funds should be allocated solely to their dedicated purpose or discontinued. Spending should occur on the basis of need or demonstrated results, not simply because dedicated funding is available. Funds collected for the TDI should be retained by the Department and not diverted to other areas of the state budget.

Recommendation:

- *Proceeds from insurance maintenance fees should be used to regulate insurance, as Texas law prescribes, and should not be diverted to programs outside the Texas Department of Insurance.*

2h. Streamlining Consumer Representation

As a separate division within TDI, the Office of Public Insurance Counsel (OPIC) supposedly represents the interests of consumers in insurance matters. Specifically, OPIC:

> Acts as an advocate for insurance consumers primarily before the Texas Department of Insurance…While OPIC does not represent individual consumers, individual complaints may point to a larger issue, suggest a pattern of insurance practices, or affect a significant number of policyholders, and therefore trigger OPIC's involvement.[xxix]

With a budget just over $1 million annually, most of OPIC's key responsibilities are the same as those of the Department of Insurance.[xxx] A separate agency within an agency is duplicative and unnecessary to represent consumer interests. The Department of Insurance notes on its own website that:

> We encourage company competition to make insurance available and affordable. We also educate consumers to help them make well-informed insurance decisions…TDI helps consumers recover millions of dollars in refunds and additional claim payments each year.[xxxi]

The Sunset Advisory Commission evaluated the continuing need for a stand-alone agency and concluded that, while it is important for the State of Texas to provide consumer protection, it is unnecessary to have these functions in two State agencies and that integrating a consumer perspective within TDI would enhance the State's balanced regulation of insurance. The report specifically noted that "having two state agencies providing consumer education on insurance is inefficient and confusing to the public." [xxxii]

Recommendation

- *Abolish the Office of Public Insurance Counsel (OPIC) and allow the Department of Insurance to take responsibility for representing the interests of consumers.*

3. Health Insurance

3a. The Impact of "Obamacare" on Texas' Health Insurance Market

Signed into law on March 23, 2010, the Patient Protection and Affordable Health Care Act (PPACA) dramatically alters health insurance arrangements for working-age Americans and their families. For the first time, the federal government is going to impose a requirement on citizens and legal residents to purchase a product in the private economy, namely government-approved health insurance. The government will also establish what constitutes an "appropriate" insurance policy, and heavily regulate the premiums that can be charged.

Begun in 2010—and generally already in place—insurance plans are no longer allowed to set a lifetime limit on benefits, deny coverage to children with pre-existing conditions, or rescind coverage once offered. Plans are also required to cover dependent children—even if they are married—up to age 26. Additional restrictions come into effect in 2014 with prohibitions against requiring waiting periods of more than 90 days, setting annual limits on benefits, or denying coverage to any individuals with pre-existing conditions. The result of these provisions is almost certain to be higher premiums, although it is impossible to determine an actuarial impact at this time.

According to the Comptroller's Office, health plans administered for state employees, as well as the University of Texas and Texas A&M systems, will all be affected by the changes to dependant coverage and limitation of waiting periods, resulting in costs well over $250 million to the State by 2019.[xxxiii] Additionally, according to recent filings with state regulators, Aetna, some BlueCross BlueShield plans and other smaller carriers have asked for premium increases of between 1% and 9% to pay for extra benefits required under PPACA. Coupled with already rising medical costs, premiums could rise as much as 20 percent. [xxxiv]

States are expected to create new "exchanges" by 2014 through which individuals and workers in smaller firms (under 100 employees) would get their insurance. However, larger employers could choose to let their workers get their insurance from these new exchanges as well instead of provided through them. The federal government would subsidize the premiums of those with incomes between 133 and 400 percent of the federal poverty line. Employers with at least 50 employees would pay taxes if any of their workers ended up in subsidized insurance through the exchanges. New high-risk pools will be temporarily established to accommodate the uninsured more immediately. Given that Texas already operates a high-risk pool for people with pre-existing conditions, Governor Perry has rightly declined to establish an additional high-risk pool within the state, instead leaving its administration up to the federal government.

Two provisions required for the 2010 plan year will have the most immediate impact on the insurance market. The federal Department of Health and Human Services (HHS) will work with states to develop a process for the annual review of premium rate increases. The process will begin with health plans filing rates with TDI, which will be reviewed and determined to be "reasonable" or not. Health plans will be required to provide HHS and TDI with written explanations of rates that been determined to be "unreasonable" and post an explanation on their website. In turn, TDI will be required to submit all of the information it collects to HHS. In a recent letter to the Association of Health Plans (AHIP), HHS

Secretary Kathleen Sebelius warned that "the Administration, in partnership with states, will not tolerate unjustified rate hikes in the name of consumer protections."[xxxv]

The other provisions required for the 2010 plan year that have insurance companies greatly concerned are the new regulations on medical loss ratios (MLR), specifically the requirement that health plans must report information on loss ratios to HHS. Beginning in 2011, insurers will be required to report what percentage of premium revenue is spent for reimbursement of clinical services, activities that improve health care quality, and all other non-claims expenses (excluding taxes, licensing or regulatory fees). Loss ratio expenses will be based on clinical services and activities that improve health care quality, which can be highly ambiguous. Beginning in 2011, insurers will be required to provide rebates to consumers if health plans do meet minimum loss ratios of 85% of larger group plans or 80% for small group and individual plans. While still unclear what the final implementation of these provisions will be, it is likely that many insurers—especially small-group plans—will leave the marketplace.

Texas has one of the most competitive insurance markets in the country with numerous carriers offering coverage in the individual and small group markets and a relatively un-concentrated market compared to other states.[xxxvi] It is highly likely that a number of smaller plans will exit the market as their business models rely heavily on brokers and carry higher administrative costs. President Obama's reforms may ultimately drive the current system into one that will feature a small number of very large health plans and virtually no smaller plans. The end result of such a shift will be significantly less competition.

A number of plans in Texas and across the country, including United Healthcare, Aetna, and Cigna, have already indicated they will no longer be offering child-only plans due to the federal government's requirement that these plans be sold on a guaranteed issue basis without any consideration of pre-existing conditions.[xxxvii] Depending upon how an enrollment process would be structured, some of these plans may or may not consider returning to this market.

Coupled with the current medical trend of increasing costs, the premium increases that are almost certain to result from the changes to the health insurance market are bad news for Texas consumers. TDI is also likely to have significantly increased regulatory and oversight responsibilities.

3b. Texas' Response to Federal Health Care Reform

In response to the passage of federal health care reform, Attorney General Abbott joined with nineteen other attorneys general in filing a lawsuit in opposition to the legislation. The lawsuit asserts that numerous aspects of the federal legislation are unconstitutional, noting especially that:

> The Constitution nowhere authorizes the United States to mandate, either directly or under threat of penalty, that all citizens and legal residents have qualifying healthcare coverage. By imposing such a mandate, the Act exceeds the powers of the United States under Article I of the Constitution and violates the Tenth Amendment to the Constitution.[xxxviii]

Congress and advocates of the legislation contend that the federal government has the authority to mandate personal insurance under the Commerce Clause contained in Article I, Section 8 of the United States Constitution. The Commerce Clause states that "[The Congress shall have power] To regulate Commerce with foreign Nations, and among the several States, and with the Indian tribes."

The authors of the health care reform legislation (H.R. 3590, 111th Congress) even attempted to head off a constitutional challenge by asserting their powers under the Commerce Clause and including the following justification in the bill itself:

> SEC. 1501. REQUIREMENT TO MAINTAIN MINIMUM ESSENTIAL COVERAGE.
>
> (a) Findings- Congress makes the following findings:
>
> (1) IN GENERAL- The individual responsibility requirement provided for in this section (in this subsection referred to as the 'requirement') is commercial and economic in nature, and substantially affects interstate commerce, as a result of the effects described in paragraph (2).
>
> (2) EFFECTS ON THE NATIONAL ECONOMY AND INTERSTATE COMMERCE- The effects described in this paragraph are the following:
>
> (A) The requirement regulates activity that is commercial and economic in nature: economic and financial decisions about how and when health care is paid for, and when health insurance is purchased.
>
> *[H.R. 3590, 111th Congress, Section 1501.]*

The attorneys general joined in voiding the law, however, counter that:

> The Act is directed to a lack of or failure to engage in activity that is driven by the choices of individual Americans. Such inactivity by its nature cannot be deemed to be in commerce or to have any substantial effect on commerce, whether interstate or otherwise.[xxxix]

The position adopted by the attorneys general is supported by a legal brief prepared by the Heritage Foundation in December 2009, which suggests that precedent is on the side of the attorneys general, noting that:

> Because the personal insurance mandate purports to reach the refusal to engage in economic activity—which is both inactivity and noneconomic—the Supreme Court could not uphold this exercise of power without admitting that the Commerce Clause has no limits, a proposition it rejected in *Lopez* and *Morrison*, and from which it did not retreat in *Raich.*[xl]

The Heritage Foundation goes on to argue that if the individual mandate were upheld by the Supreme Court:

> Congress would have the unlimited power to regulate, prohibit, or mandate any or all activities in the United States. Such a doctrine would abolish any limit on federal power and alter the fundamental relationship of the national government to the states and the people. For this reason it is highly doubtful that the Supreme Court will uphold this assertion of power.[xli]

Even the New Deal-era Supreme Court wrote that:

> The authority of the federal government may not be pushed to such an extreme as to destroy the distinction, which the commerce clause itself establishes, between commerce 'among the several states' and the internal concerns of a state.[xlii]

While much litigation in the case remains, in December 2010, a federal court in Virginia stuck down the portion of PPACA that requires a person to purchase health insurance or pay a penalty- often referred to as the "individual mandate."[xliii] In January 2011, a Florida federal judge also ruled against the current administration and in favor of 26 states over the constitutionality of the PPACA.[xliv]

The second opinion, however, differs from the first in that the second opinion found that the individual mandate of the PPACA is "not severable" from other portions of the health care act. As a result, the second court struck down not only the individual mandate, but the entire PPACA.

In the opinion, Judge Roger Vinson first rejected the states' argument that the PPACA exceeds the federal government's spending powers because it is coercive. The states argued that the PPACA left them in an impossible situation- either exit Medicaid and forfeit federal funds, or remain in Medicaid as modified by the PPACA. Either case, the states argued, would lead to state budget disasters. The court rejected this argument, citing precedent that state participation in Medicaid is voluntary, not coercive.

Turning to the individual mandate portion of the PPACA, the court found that it exceeded the scope of Congress's power under the Commerce Clause of the federal Constitution. While the Commerce Clause empowers Congress to regulate commercial activity, the court concluded that the decision by an individual to not purchase health insurance is inactivity, not activity. Therefore, Congress cannot compel a person to purchase health insurance.

After deciding that the individual mandate was unconstitutional, the court considered the question of whether it was "severable," from the PPACA- in short, whether the remaining parts of the statute could be salvaged. The court pointed out that the Obama administration itself had referred to the individual mandate as an "essential" part of the PPACA fourteen times in its briefs on the case. Moreover, Congress originally included a "severability clause" in a draft of the PPACA (which states that if a portion of a law is found unconstitutional, the rest of it should not be affected), but removed that clause before the statute was enacted, thus raising doubt about whether Congress intended for the PPACA to be implemented if the individual mandate was struck down.

Four federal courts have now split evenly over the constitutionality of PPACA. Given this split and the importance of the health care issue, the Supreme Court is likely to eventually decide the issue. If the Supreme Court determines that the Commerce Clause does not give the federal government the power to compel individuals to purchase a specific product (health insurance), it would be a major victory for limited government and personal liberty.

3c. Health Care Freedom for Texas

In addition to continuing to support legal challenges to the constitutionality of the health care reform legislation, state legislators should also introduce "health care freedom" legislation similar to that which passed the Arizona Legislature in 2009. The Arizona legislation has two core components: the first "protects a person's right to participate or not in any health care system, and prohibits the government from imposing fines or penalties on that person's decision," and the second component "protects the right of individuals to purchase—and the right of doctors to provide—lawful medical services without

government fine or penalty."[xlv] Similar legislation has also been signed into law in Virginia by Governor Bob McDonnell[xlvi], and is being pursued in at least 38 states.[xlvii]

The Arizona voters successfully upheld this measure on their state ballot on November 2, 2010. Legislators in Texas should adopt a similar approach by filing the legislation to amend the Texas Constitution. It should be noted that health care freedom legislation is *not* nullification of the federal health care reform legislation. It is simply a state-level response that rejects the authority of Congress to pass such legislation and recognizes the right of citizens not to participate in the constitutionally void, federally-mandated system *if they do not wish to do so.*

The United States' federal system of government relies on the notion that states are equally charged with protecting the rights of their citizens. Underscoring this point, former Supreme Court Justice William Brennan argued that "the legal revolution which has brought federal law to the fore must not be allowed to inhibit the independent protective force of state law — for without it, the full realization of our liberties cannot be guaranteed."[xlviii]

Arizona's measure should serve as a model for other states interested in protecting the liberty of its citizens and reaffirming the limited role granted to the federal government in our Constitution.

Recommendation

- *Pass Health Care Freedom Legislation that protects Texas citizens' right to participate or not in any health care system and prohibits the government from imposing fines or penalties on that person's decision. Legislation such as House Joint Resolution 51 (82R) by Representative Christian is recommended. HJR 51 would amend the Texas Constitution to the effect that "each individual in this state has the right to choose or decline to choose health insurance coverage without penalty or sanction or threat of penalty or sanction."*

3d. Creating a Pro-Consumer Health Insurance Exchange in Texas

The overwhelming majority of Americans with health insurance receive it through their employer. While this system has worked for decades to help ensure that millions of Americans have health coverage and has significantly expanded group coverage, it also limits the decision-making abilities of consumers. Employment-based health care coverage is almost always offered on a "defined benefit" basis in which the employer specifies the package of benefits offered to its workers and determines the share of premiums its workers must pay, regardless of the personal preferences of the workers. There is little or no personal choice; little or no portability of coverage in a rapidly changing economy where workers are changing jobs and careers; and little or no flexibility in tailoring insurance coverage to meet individual and family needs. Traditional employer-sponsored health insurance systems have also not found a way to successfully control the rapidly rising costs of health care.

PPACA requires states to create new insurance marketplaces, known as "exchanges," for people and small businesses to buy health insurance coverage. U.S. citizens and legal residents who are not incarcerated would qualify to buy coverage in such an exchange. States will be allowed to expand their exchanges to provide coverage for large employers in 2017.

PPACA creates two types of state-based exchanges—one through which individuals may purchase qualified coverage, and another through which small businesses with up to 100 employees can purchase qualified coverage. States may choose to create one exchange program that serves both individuals and small businesses. Beginning January 1, 2014, four categories of plans plus a separate catastrophic plan will be offered through the exchanges. Each category of plans will offer essential benefits as determined by HHS. Plan benefits, premiums, and enrollee out-of-pocket expenses will vary depending on the plan chosen. Plans will cover 60 to 90 percent of the medical expenses, again depending on which plan the enrollee selects.

Premium subsidies will be available for individuals and families with incomes between 133 percent ($14,404 for individuals and $29,326 for a family of four) and 400 percent ($43,320 for individual or $88,200 for a family) of the federal poverty level. These subsidies could be used toward the purchase of health insurance from an exchange.

While many of the parameters surrounding the creation of the exchange are determined by HHS, there is still great flexibility for Texas to create an exchange with free-market and consumer- oriented principles. Such a system—if implemented correctly—has the potential to be a significant improvement on the current employer-based system by allowing greater competition among plans, which would inherently help to control costs and the over-usage of health care. Despite the fact that it was mandated by PPACA and imposes a new mandate on Texas, the creation of a state health insurance exchange provides an opportunity for the state to fundamentally reshape and reform the health insurance marketplace. Since insurance regulation has traditionally been a state function, Texas already has a viable existing regulatory infrastructure, as well as the experience necessary to implement a successful Exchange.

It is also important to remember that if Texas were to refuse to set up an exchange network, the federal government would establish its own national exchange that could serve uninsured Texans and small businesses. It is highly likely that a federal system would not be as innovative or market-oriented as one maintained and controlled by our own state.

The state of Utah provides a very instructive example for Texas in establishing an exchange network with the maximum amount of flexibility for consumers, while also ensuring a competitive environment for insurers.

Utah began a health care reform effort in 2005, which produced a health insurance exchange that allows participating workers to choose coverage from competing insurers. Contrary to a traditional “defined benefit” arrangement, Utah’s exchange operates as a “defined contribution” option under which the employer offers its workers a tax-free contribution toward the health plan of their choice. Each worker then chooses the coverage they prefer from a menu of plans with different benefits. The state ensures that all plans offered through the exchange qualify as employer-sponsored coverage under state and federal law so that premiums can be paid on a pre-tax basis. [xlix]

Because each worker can choose the coverage they prefers from a menu of plans under the defined-contribution option, it also increases the likelihood that younger workers, who generally have lower earnings, will be able to find a plan that meets their needs and is affordable. Utah’s program also include

a number of other pro-consumer features such as a "premium aggregator" that will allow individuals and families to combine contributions from more than one employer.[l]

By reducing the level of effort and risk to employers in offering health benefits, small companies will be more likely to begin offering their workers coverage. Utah's reforms will free up employers to focus on their core business because they will no longer have to administer health benefits. Because the exchange includes a rating system reform, employers will also know exactly how much health benefits cost each year.[li]

In addition, the defined-contribution option makes it practical for employers to offer their part-time or seasonal workers prorated coverage contributions, with a reasonable expectation that those workers can then obtain coverage by combining that employer's contribution with funds from other sources.

It is important to note that, unlike the federal health care reform efforts, Utah policymakers have taken care to preserve existing options while creating new alternatives. Utah employers are still be able to offer traditional defined-benefit coverage if they so choose. Utah lawmakers also did not create any new bureaucracies to administer their exchange, and instead contracted with private companies experienced in health insurance and employee benefits to operate their internet-based exchange. They have also not imposed any new coverage mandates and have actually reduced coverage requirements in some cases, giving insurers flexibility to tailor their products specifically to consumer preferences..[lii]

Utah is also continuing to tweak its exchange to respond to the needs of businesses and consumers. While originally intended for the small-group market, later legislative reforms in Utah expanded the extension of the defined-contribution option to large employers beginning in 2012. They are even beginning to pilot to the defined-contribution option with a group of eight of the state's biggest employers now, in response to demand from large employers within Utah.[liii]

Texas could follow Utah's example by implementing customized state-level reforms that empower consumers rather than the federal bureaucracy. According to the Heritage Foundation, Utah's efforts run on an annual budget of roughly $600,000, thus not significantly impacting the State's budget.[liv]

If the Texas Legislature and other State Officials begin planning and establishing the necessary framework for the Exchange, as well as setting into place the policies that will be required for the successful operation of Texas' Health Insurance Exchange, the following principles should guide planning and implementation:

- Marketplace: The Texas Health Insurance Exchange should allow our existing health insurance market to continue to operate outside the Exchange. While the Exchange could provide a terrific opportunity to create a new marketplace for affordable health insurance coverage, it is critical that the Exchange supplements, not replaces, the existing health insurance market that currently provides coverage to millions of Texans. The Exchange should ensure a level, competitive playing field in order to avoid adverse selection between the new market created in the Exchange and the existing market outside of the Exchange.

- Participation: The Texas Health Insurance Exchange should include any willing health insurance plan that provides the essential health benefits package, satisfies cost sharing requirements, and offers the required levels of coverage. The Exchange should be very careful to ensure that employers and consumers retain the right to choose their health insurance plans by making certain that all qualified

health insurance plans are allowed to offer coverage through the Exchange, rather than allowing the government to determine which plans will and will not be offered. Further, statutes and rules must be written in such a way that clarifies that health insurance carriers are under no obligation to participate in Medicaid or CHIP as a qualification to participate in the Exchange. Further, statutes and rules must also be clear in expressing that participation in Exchange plans, Medicaid, or CHIP is not a qualification for the licensure of Texas hospitals, physicians, and other providers.

- Administration: While the establishment of an Exchange in Texas will require an unprecedented amount of collaboration between state agencies, stakeholders and the health insurance industry as a whole, it is imperative that the Texas Health Insurance Exchange be operated as a nonprofit organization established by statute rather than operated directly by a state agency.

- Governance Structure: The Texas Insurance Exchange should be governed by qualified board members and should be managed in an open and transparent manner.

- Limit on Enforceability: Should the United States Supreme Court uphold the federal court ruling by Judge Vinson – that the PPACA individual health insurance mandate is unconstitutional and not severable from the entire Act – and effectively overturn PPACA, then all work should cease on an Exchange. The same would be true if Congress defunds portions of PPACA related to insurance subsidies, repeals the insurance mandate, or overturns the entire Act.

Recommendation

- *The 2011 Legislative Session may be Texas' only opportunity to act in order to ensure that the foundation upon which to build an effective and efficient Health Insurance Exchange in Texas is established by direction of the Texas Legislature rather than the Department of Health and Human Services. [See HB 636, 82R by Zerwas].*

4. Conclusion

It is increasingly clear that strict regulatory regimes in the insurance industry are an outdated and ineffective way to protect consumers in the insurance market. By increasing competition among insurers, premium rates are driven downward and consumers are left with more companies from which to choose insurance products. The success of Texas in de-regulating other industries – such as telecommunications and electric retailers – should continue to be extended to the insurance market, building on the reforms enacted over the past decade. With the increasing burdens of cost and regulation on the health insurance market, it is critical that the remainder of the insurance industry operate as effectively and efficiently as possible.

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