Consumer Federation of America

STATEMENT OF

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BEFORE THE

SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

"EXAMINATION AND OVERSIGHT OF THE CONDITION AND REGULATION OF THE INSURANCE INDUSTRY"

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Mr. Chairman and Members of the Committee, thank you for your invitation to testify today. America's insurance consumers, including small businesses, are vitally interested in how insurance will be regulated in the future. Therefore, your hearing is most timely. We especially appreciate the fact that the Committee is beginning its review with an overall examination of insurance regulation – why it exists, what are its successes and failures – rather than solely reviewing proposed legislation, such as the Oxley-Baker proposal or the optional federal charter approach.[1] In order to identify whether federal legislation is necessary and what should be its focus, it obviously makes a great deal of sense for the Committee to first conduct a thorough assessment of the current situation. If the "problem" isn't properly diagnosed, the "solutions" that Congress enacts will be flawed.

Why is Regulation of Insurance Necessary?

The rationale behind insurance regulation is to promote beneficial competition and prevent destructive or harmful competition in various areas.

Insolvency: One of the reasons for regulation is to prevent competition that routinely causes insurers to go out of business, leaving consumers unable to collect on claims. Insolvency regulation has historically been a primary focus of insurance regulation. After several insolvencies in the 1980s, state regulators and the National Association of Insurance Commissioners (NAIC) enacted risk-based capital standards and implemented an accreditation program to help identify and prevent future insolvencies. As far fewer insolvencies occurred in the 1990s, state regulators appear to be doing a better job.

Unfair and Deceptive Policies and Practices: Insurance policies, unlike most other consumer products or services, are contracts that promise to make certain payments under certain conditions at some point in the future. (Please see the fact sheet on why insurance is different from many other products for regulatory purposes that follows the attached September 9, 2004 letter.) Consumers can easily research the price, quality and features of a television, but they have very limited ability to do so on insurance policies. Because of the complicated nature of insurance policies, consumers rely on the representations of the seller/agent to a far greater extent than for other products. Regulation exists to prevent competition that fosters the sale of unfair and deceptive policies, sales and claims practices.

Unfortunately, states have not fared as well in this area. Rather than acting to uncover abuses and instigate enforcement actions, states have often *reacted* after lawsuits or news stories brought bad practices to light. For example, the common perception among regulators that "fly-by-night" insurance companies were primarily responsible for deceptive and misleading practices was shattered in the late 1980s and early 1990s by widespread allegations of such practices by household names such as MetLife, John Hancock, and Prudential. For instance, MetLife sold plain whole life policies to nurses as "retirement plans," and Prudential unilaterally replaced many customers' whole life

[1] CFA strongly opposes both of these proposals as undermining needed consumer protections.

policies with policies that didn't offer as much coverage. Though it is true that state regulators eventually took action through coordinated settlements, the allegations were first raised in private litigation; many consumers were defrauded before regulators acted.

One of the problems insurance departments face is a lack of resources for market conduct regulation. CFA's surveys indicate it would take five to seven years alone for states to complete market conduct exams of just domestic insurance companies and over 50 years for all companies. States making up 75 percent of the country's population have inadequate resources. It is not surprising that many harmful practices fall through the cracks.

Insurance Availability: Some insurance is mandated by law or required to complete financial transactions, such as mortgage loans. In a normal competitive market, participants compete by attempting to sell to all consumers seeking the product. However, in the insurance market, participants compete by attempting to "select" only the most profitable consumers. This selection competition leads to availability problems and redlining.[2] Regulation exists to limit destructive selection competition that harms consumers and society.

Lawsuits brought by fair housing groups and the Department of Housing and Urban Development (HUD) have revealed that insurance availability problems and unfair discrimination exist and demonstrate a lack of oversight and attention by many of the states. NAIC had ample opportunity after its own studies indicated that these problems existed to move to protect consumers. It retreated, however, when the insurers threatened to cut off funding for its insurance information database, a primary source of NAIC income.

One obvious solution to discrimination and availability problems is to require insurers to disclose information about policies written by zip code, and about specific underwriting guidelines that are used to determine eligibility and rates. Such disclosure

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[2] The industry's reliance on selection competition can have negative impacts on consumers. Insurance is a risk spreading mechanism. Insurance aggregates consumers' premiums into a common fund from which claims are paid. Insurance is a contractual social arrangement, subject to regulation by the states.

The common fund in which wealth is shifted from those without losses (claims) to those with losses (claims) is the reason that the contribution of insurance companies to the Gross National Product of the United States is measured as premiums less losses for the property/casualty lines of insurance. The U.S. government recognizes that the losses are paid from a common fund and thus are a shift in dollars from consumers without claims to those with claims, not a "product" of the insurance companies.

Competition among insurers should be focused where it has positive effects, e.g., creating efficiencies, lowering overhead. But rather than competing on the basis of the expense and profit components of rates, the industry has relied more on selection competition, which merely pushes claims from insurer to insurer or back on the person or the state. States have failed to control against the worst ravages of selection competition (e.g. redlining).

Some of the vices of selection competition that need to be addressed include zip code or other territorial selection; the potential for genetic profile selection; income (or more precisely credit report) selection; and selection based on employment. Targeted marketing based solely on information such as income, habits, and preferences. leaves out consumers in need of insurance, perhaps unfairly.

would promote competition and benefit consumers; but state regulators, for the most part, have refused to require such disclosure in the face of adamant opposition from the industry. Regulators apparently agree with insurers that such information is a "trade secret" despite the absence of legal support for such a position. In addition, though insurance companies compete with banks that must meet data disclosure and lending requirements in underserved communities under the Community Reinvestment Act ("CRA"), insurers refuse to acknowledge a similar responsibility to communities.

Reverse Competition: In certain lines of insurance, insurers market their policies to a third party, such as creditors or auto dealers, who, in turn, sell the insurance to consumers on behalf of the insurer for commission and other compensation. This compensation is often not disclosed to the consumer. Absent regulation, reverse competition leads to higher -- not lower -- prices for consumers because insurers "compete" to offer greater compensation to third party sellers, driving up the price to consumers.

The credit insurance market offers a perfect example of reverse competition. Every few years, consumer groups issue reports about the millions of dollars that consumers are overcharged for credit insurance. Despite the overwhelming evidence that insurers do not meet targeted loss ratios in most states, many regulators have not acted to protect consumers by lowering rates.

The markets for low value life insurance and industrial life insurance are characterized by overpriced and inappropriately sold policies and a lack of competition. This demonstrates the need for standards that ensure substantial policy value and clear disclosure. Insurers rely on consumers' lack of sophistication to sell these overpriced policies. With some exceptions, states have not enacted standards that ensure value or provide timely, accurate disclosure. Consumers continue to pay far too much for very little coverage.

Information for Consumers: True competition can only exist when purchasers are fully aware of the costs and benefits of the products and services they purchase. Because of the nature of insurance policies and pricing, consumers have had relatively little information about the quality and comparative cost of insurance policies. Regulation is needed to ensure that consumers have access to information that is necessary to make informed insurance purchase decisions and to compare prices.

While information and outreach efforts of states have improved, states and the NAIC have a long way to go. Some states have succeeded in getting good information out to consumers, but all too often the marketplace and insurance regulators have failed to ensure adequate disclosure. Their failure affects the pocketbooks of consumers, who cannot compare adequately on the basis of price.

In many cases, insurers have stymied proposals for effective disclosure. For decades, consumer advocates pressed for more meaningful disclosure of life insurance policies, including rate of return disclosure, which would give consumers a simple way to determine the value of a cash-value policy. Today, even insurance experts can't determine which policy is better without running the underlying information through a computer. Regulators resisted this kind of disclosure until the insurance scandals of the 1990s involving widespread misleading and abusive practices by insurers and agents prompted states and the NAIC to develop model laws to address these problems. Regulators voiced strong concerns and promised tough action to correct these abuses. While early drafts held promise and included some meaningful cost-comparison requirements, the insurance industry successfully lobbied against the most important provisions of these proposals that would have made comparison-shopping possible for normal consumers. The model disclosure law that NAIC eventually adopted is inadequate for consumers trying to understand the structure and actual costs of policies.

California adopted a rate of return disclosure rule a few years ago for life insurance (similar to an APR in loan contracts) that would have spurred competition and helped consumers comparison-shop. Before consumers had a chance to become familiar with the disclosures, however, the life insurance lobby persuaded the California legislature to scuttle it.

Are the Reasons for Insurance Regulation Still Valid?

The reasons for effective regulation of insurance are as relevant, or in some instances even more relevant, today than five or ten years ago:

- Advances in technology now provide insurers access to extraordinarily detailed data about individual customers and allow them to pursue selection competition to an extent unimaginable ten years ago.
- Insurance is being used by more Americans not just to protect against future risk, but as a tool to finance an increasing share of their future income, e.g., through annuities.
- Increased competition from other financial sectors (such as banking) for the same customers could serve as an incentive for misleading and deceptive practices and market segmentation, leaving some consumers without access to the best policies and rates. If an insurer can't compete on price with a more efficient competitor, one way to keep prices low is by offering weaker policy benefits (i.e., "competition" in the fine print).
- States and lenders still require the purchase of auto and home insurance. Combining insurer and lender functions under one roof, as allowed by the Gramm Leach Bliley Act, could increase incentives to sell insurance as an add-on to a loan (perhaps under tie-in pressure) – or to inappropriately fund insurance policies through high-cost loans.

As consumers are faced with these changes, it is more important than ever that insurance laws are updated and the consumer protection bar is raised, not lowered.

Given that Regulation is Important for Consumers, Who Should Regulate -- the States or the Federal Government?

Consumers do not care who regulates insurance; we only care that the regulatory system be excellent. Consumer advocates have been (and are) critical of the current state-based system, but we are not willing to accept a federal system that guts consumer protections in the states and establishes one uniform but weak set of regulatory standards.

I am one of very few people who have served both as a state regulator (Texas Insurance Commissioner) and as a federal regulator (Federal Insurance Administrator when the Federal Insurance Administration was in HUD and had responsibility for the co-regulation of homeowners' insurance in the FAIR Plans, as well as flood and crime insurance duties.) I know that either a federal or the state system can succeed or fail in protecting consumers. What is critical is not the locus of regulation, but the quality of the standards and the effectiveness of enforcement of those standards.

Both a state and a federal system have potential advantages and disadvantages. Here are some of them:

Item	Federal	State
Experience overseeing all aspects of insurance regulation?	No	Yes
Responsive to local needs?	No	Yes
Handle individual complaints promptly and effectively?	No	Yes
Limited impact if regulatory mistakes are made?	No	Yes
Not subject to political pressure from national insurers?	No	No
Not subject to political pressure from local insurers?	Yes	No
More uniform regulatory approach?	Yes	No
Can easily respond to micro-trends impacting only a region or a state?	No	Yes
Can easily respond to macro-trends that cross state borders?	Yes	No
Has greater resources, like date processing capacity?	Yes	No

Despite many weaknesses that exist in insurance regulation at the state level, a number of states do have high-quality consumer protections. Moreover, the states also have extensive experience regulating insurer safety and soundness and an established system to address and respond to consumer complaints. The burden is on those who for opportunistic reasons now want to shift away from 150 years of state insurance regulation to show that they are not asking federal regulators and American consumers to accept a dangerous "pig in a poke" that will harm consumers.

CFA agrees that better coordination and more consistent standards for licensing and examinations are desirable and necessary – as long as the standards are of the highest – and not the lowest – quality. We also agree that efficient regulation is important, because consumers pay for inefficiencies. CFA participated in NAIC meetings over many months helping to find ways to eliminate inefficient regulatory practices and delays, even helping to put together a 30-day total product approval package. Our concern is not with cutting fat, but with removing regulatory muscle when consumers are vulnerable.

Why Have Insurers Suddenly Embraced Federal Regulation?

The recent conversion of insurers to the concept of federal regulation is based solely on the notion that such regulation would be weaker. Insurers have, on occasion, sought federal regulation when the states increased regulatory control and the federal regulatory attitude was more laissez-faire. Thus, in the 1800s, the industry argued in favor of a federal role before the Supreme Court in Paul v. Virginia, but the court ruled that the states controlled because insurance was intrastate commerce.

Later, in the 1943 SEUA case, the Court reversed itself, declaring that insurance was interstate commerce and that federal antitrust and other laws applied to insurance. By this time, Franklin Roosevelt was in office and the federal government was a tougher regulator than were the states. The industry sought, and obtained, the McCarran-Ferguson Act. This law delegated excusive authority for insurance regulation to the states, with no routine Congressional review. The Act also granted insurers a virtually unheard of exemption from antitrust laws, which allowed insurance companies to collude in setting rates and to pursue other anticompetitive practices without fear of federal prosecution.

From 1943 until recently, the insurance industry has violently opposed *any* federal role in insurance regulation. In 1980, insurers successfully lobbied to stop the Federal Trade Commission from investigating deceptive acts and practices *of any kind* in the insurance industry. They also convinced the White House that year to eliminate the Federal Insurance Administration's work on insurance matters other than flood insurance. Since that time, the industry has successfully scuttled any attempt to require insurers to comply with federal antitrust laws and has even tried to avoid complying with federal civil rights laws.

Notice that the insurance industry is very pragmatic in their selection of a preferred regulator. They always favor the least regulation. It is not surprising that, today, the industry would again seek a federal role at a time they perceive little regulatory interest at the federal level. But, rather than going for full federal control, they have learned that there are ebbs and flows in regulatory oversight at the federal and state levels, so they seek the ability to switch back and forth at will.

Further, the insurance industry has used the possibility of an increased federal role to pressure NAIC and the states into gutting consumer protections over the last three or four years. Insurers have repeatedly warned states that the only way to preserve their control over insurance regulation is to weaken consumer protections.[3] They have been

[3] The clearest attempt to inappropriately pressure the NAIC occurred at their spring 2001 meeting in Nashville. There, speaking on behalf of the entire industry, Paul Mattera of Liberty Mutual Insurance Company told the NAIC that they were losing insurance companies every day to political support for the federal option and that their huge effort in 2000 to deregulate and speed product approval was too little, too late. He called for an immediate step-up of deregulation and measurable "victories" of deregulation to stem

assisted in this effort by a series of House hearings, which rather than focusing on the need for improved consumer protection have served as a platform for a few Representatives to issue ominous statements calling on the states to further deregulate insurance oversight, "or else." Most recently, some House members have floated a "road map" for insurance deregulation (known as the "SMART" bill), a plan that would greatly harm America's insurance consumers.

This strategy of "whipsawing" state regulators to lower standards benefits all elements of the insurance industry, even those that do not support any federal regulatory approach. Even if Congress does nothing, the threat of federal intervention is enough to scare state regulators into acceding to insurer demands.

Unfortunately for consumers, the strategy has already paid off, before the first insurance bill is ever marked up in Congress. In the last few years, the NAIC has moved suddenly to cut consumer protections adopted over a period of decades. The NAIC has also failed to act in the face of a number of serious problems facing consumers in the insurance market.

<u>NAIC Failures To Act</u>

1. Failure to do anything about abuses in the small face life market. Instead, NAIC adopted an incomprehensible disclosure on premiums exceeding benefits, but did nothing on overcharges, multiple policies, or unfair sales practices.

2. Failure to do anything meaningful about unsuitable sales in any line of insurance. Suitability requirements still do not exist for life insurance sales

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the tide. In a July 9, 2001 <u>Wall Street Journal</u> article by Chris Oster, Mattera admitted his intent was to get a "headline or two to get people refocused." His remarks were so offensive that I went up to several top commissioners immediately afterwards and said that Materra's speech was the most embarrassing thing I had witnessed in 40 years of attending NAIC meetings. I was particularly embarrassed since no commissioner challenged Mattera and many had almost begged him to grant them more time to deliver whatever the industry wanted.

Jane Bryant Quinn, in her speech to the NAIC on October 3, 2000, said: "Now the industry is pressing state regulators to be even more hands-off with the threat that otherwise they'll go to the feds." So other observers of the NAIC see this pressure as potentially damaging to consumers.

Larry Forrester, President of the National Association of Mutual Insurance Companies (NAMIC), wrote an article in the <u>National Underwriter</u> of June 4, 2000. In it he said, "…how long will Congress and our own industry watch and wait while our competitors continue to operate in a more uniform and less burdensome regulatory environment? Momentum for federal regulation appears to be building in Washington and state officials should be as aware of it as any of the rest of us who have lobbyists in the nation's capital…NAIC's ideas for speed to market, complete with deadlines for action, are especially important. Congress and the industry will be watching closely…The long knives for state regulation are already out…"

In a press release entitled "Alliance Advocates Simplification of Personal Lines Regulation at NCOIL Meeting; Sees it as Key to Fighting Federal Control" dated March 2, 2001, John Lobert, Senior VP of the Alliance of American Insurers, said, "Absent prompt and rapid progress (in deregulation) … others in the financial services industry – including insurers – will aggressively pursue federal regulation of our business…"

even in the wake of the remarkable market conduct scandals of the late 1980s and early 1990s. A senior annuities protection model was finally adopted (after years of debate) that is so limited as to do nothing to protect consumers.

3. Failure to call for collection and public disclosure of market performance data after years of requests for regulators to enhance market data, as NAIC weakened consumer protections. How does one test whether a market is workably competitive without data on market shares by zip code and other tests?

4. Failure to do anything as an organization on the use of credit scoring for insurance purposes. In the absence of NAIC action, industry misinformation about credit scoring has dominated state legislative debates. NAIC's failure to analyze the issue and perform any studies on consumer impact, especially on lower income consumers and minorities, has been a remarkable dereliction of duty.

5. Failure to address problems with risk selection. There has not even been a discussion of insurers' explosive use of underwriting and rating factors targeted at socio-economic characteristics: credit scoring, check writing, prior bodily injury coverage amounts purchased by the applicant, prior insurer, prior non-standard insurer, not-at-fault claims, not to mention use of genetic information, where Congress has had to recently act to fill the regulatory void.

6. Failure to do anything on single premium credit insurance abuses.

7. Failure to take recent steps on redlining or insurance availability or affordability. Many states no longer even look at these issues, 30 years after the federal government issued studies documenting the abusive practices of insurers in this regard. Yet, ongoing lawsuits continue to reveal that redlining practices harm the most vulnerable consumers.

<u>NAIC Rollbacks Of Consumer Protections</u>

1. The NAIC pushed through small business property/casualty deregulation, without doing anything to reflect consumer concerns (indeed, even refusing to tell consumer groups why they rejected their specific proposals) or to upgrade "back-end" market conduct quality, despite promises to do so. As a result, many states adopted the approach and have rolled back their regulatory protections for small businesses. Nebraska and New Hampshire joined the list of states that have deregulated just this year.

2. States are rolling back consumer protections in auto insurance as well. New Jersey, Texas, Louisiana, and New Hampshire have done so in the last two years.

3. Last year, the NAIC just terminated free access for consumers to the annual statements of insurance companies at a time when the need for enhanced disclosure is needed if price regulation is to be reduced.

Can Competition Alone Guarantee a Fair, Competitive Insurance Market?

Consumers, who over the last 30 years have been the victims of vanishing premiums, churning, race-based pricing, creaming, and consumer credit insurance policies that pay pennies in claims per dollar in premium, are not clamoring for such policies to be brought to market with even less regulatory oversight than in the past. The fact that "speed-to-market" has been identified as a vital issue in modernizing insurance regulation demonstrates that some policymakers have bought into insurers' claims that less regulation benefits consumers. We disagree. We think smarter, more efficient regulation benefits both consumers and insurers and leads to more beneficial competition. Mindless deregulation, on the other hand, will harm consumers.

The need for better regulation that benefits both consumers and insurers is being exploited by some in the insurance industry to eliminate the most effective aspects of state insurance regulation such as rate regulation, in favor of a model based on the premise that competition alone will protect consumers.[4] We question the entire

[4] If America moves to a "competitive" model, certain steps must first be taken to ensure "true competition" and prevent consumer harm. First, insurance lines must be assessed to determine whether a competitive model, e.g., the alleviation of rate regulation, is even appropriate. This assessment must have as its focus how the market works for consumers. For example, states cannot do away with rate regulation of consumer credit insurance and other types of insurance subject to reverse competition. The need for relative cost information and the complexity of the line/policy are factors that must be considered.

If certain lines are identified as appropriate for a "competitive" system, before such a system can be implemented, the following must be in place:

- Policies must be transparent: Disclosure, policy form and other laws must create transparent policies. Consumers must be able to comprehend the policy's value, coverage, actual costs, including commissions and fees. If consumers cannot adequately compare actual costs and value, and if consumers are not given the best rate for which they qualify, there can be no true competition.
- Policies should be standardized to promote comparison-shopping.
- Antitrust laws must apply.
- Anti-rebate, anti-group and other anti-competitive state laws must be repealed.
- Strong market conduct and enforcement rules must be in place with adequate penalties to serve as an incentive to compete fairly and honestly.
- Consumers must be able to hold companies legally accountable through strong private remedies for losses suffered as a result of company wrongdoing.
- Consumers must have knowledge of and control over flow and access of data about their insurance history through strong privacy rules.
- There must be an independent consumer advocate to review and assess the market, assure the public that the market is workably competitive, and determine if policies are transparent.

Safeguards to protect against competition based solely on risk selection must also be in place to prevent redlining and other problems, particularly with policies that are subject to either a public or private mandate. If a competitive system is implemented, the market must be tested on a regular basis to make sure that the system is working and to identify any market dislocations. Standby rate regulation should be available in the event the "competitive model" becomes dysfunctional.

foundation behind the assumption that virtually no front-end regulation of insurance rates and terms coupled with more back-end (market conduct) regulation is better for consumers. The track record of market conduct regulation has been extremely poor. As noted above, insurance regulators rarely are the first to identify major problems in the marketplace.

Given this track record, market conduct standards and examinations by regulators must be dramatically improved to enable regulators to become the first to identify and fix problems in the marketplace and to address market conduct problems on a national basis. From an efficiency and consumer protection perspective, it makes no sense to lessen efforts to prevent the introduction of unfair and inappropriate policies in the marketplace. It takes far less effort to prevent an inappropriate insurance policy or market practice from being introduced than to examine the practice, stop a company from doing it and provide proper restitution to consumers after the fact.

The unique nature of insurance policies and insurance companies requires more extensive front-end regulation than other consumer commodities. And while insurance markets can be structured to promote beneficial price competition, deregulation does not lead to, let alone guarantee, such beneficial price competition.

Front-end regulation should be designed to prevent market conduct problems from occurring instead of inviting those problems to occur. It should also promote beneficial competition, such as price competition and loss mitigation efforts, and deter destructive competition, such as selection competition, and unfair sales and claims settlement practices. Simply stated, strong, smart, efficient and consistent front-end regulation is critical for meaningful consumer protection and absolutely necessary to any meaningful modernization of insurance regulation.

Is Regulation Incompatible With Competition?

The insurance industry promotes a myth: regulation and competition are incompatible. This is demonstrably untrue. Regulation and competition both seek the same goal: the lowest possible price consistent with a reasonable return for the seller. There is no reason that these systems cannot coexist and even compliment each other.

The proof that competition and regulation can work together to benefit consumers and the industry is the manner in which California regulates auto insurance under Proposition 103. Indeed, that was the theory of the drafters (including me) of Proposition 103. Before Proposition 103, Californians had experienced significant price increases under a system of "open competition" of the sort the insurers now seek at the federal level. (No regulation of price is permitted but rate collusion by rating bureaus is

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If the industry will not agree to disclosing actual costs, including all fees and commissions, ensuring transparency of policies, strong market conduct rules and enforcement then it is not advocating true competition, only deregulation.

allowed, while consumers receive very little help in getting information.) Proposition 103 sought to maximize competition by eliminating the state antitrust exemption, laws that forbade agents to compete, laws that prohibited buying groups from forming, and so on. It also imposed the best system of prior approval of insurance rates and forms in the nation, with very clear rules on how rates would be judged.

As our in-depth study of regulation by the states revealed,[5] California's regulatory transformation -- to rely on both maximum regulation and competition -- has produced remarkable results for auto insurance consumers and for the insurance companies doing business there. The study reported that insurers realized very nice profits, above the national average, while consumers saw the average price for auto insurance drop from \$747.97 in 1989, the year Proposition 103 was implemented, to \$717.98 in 1998. Meanwhile, the average premium rose nationally from \$551.95 in 1989 to \$704.32 in 1998. California's rank dropped from the third costliest state to the 20th.

I can update this information through 2001.[6] As of 2001, the average annual premium in California was \$688.89 (23rd in the nation) versus \$717.70 for the nation. So, from the time California went from reliance simply on competition as insurers envisioned it to full competition and regulation, the average auto rate fell by 7.9 percent while the national average rose by 30.0 percent. A powerhouse result!

How Can Uniformity be Achieved Without Loss of Consumer Protections?

CFA would endorse a more uniform national or multi-state approach if certain rigorous conditions were met. The attached fact sheet, *Consumer Principles and Standards for Insurance Regulation,* provides detailed standards that regulators should meet to properly protect consumers, whether at the state, multi-state or national level. It should be noted that none of the proposals offered by insurers or on behalf of insurers (such as the Oxley-Baker "SMART" proposal) come close to meeting these standards.

One obvious vehicle for multi-state enforcement of insurance standards is the NAIC. We have favored empowering the NAIC to implement such a multi-state approach only if the NAIC's decision-making procedures are overhauled to make it a more transparent, accountable body with meaningful regulatory powers. As stated above, recent NAIC failures demonstrate that it is not an impartial regulatory body that can be counted on to adequately consider consumer needs.

Because of its historical domination by the insurance industry, consumer organizations are extremely skeptical about its ability to confer national treatment in a fair and democratic way. It is essential that any federal legislation to empower the NAIC include standards to prevent undue industry influence and ensure the NAIC can operate as an effective regulatory entity, including:

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[5] "Why Not the Best? The Most Effective Auto Insurance Regulation in the Nation," June 6, 2000; www.consumerfed.org.)

[6] State Average Expenditures & Premiums for Personal Automobile Insurance in 2001, NAIC, July 2003.

- Democratic processes/accountability to the public, which must include: notice and comment rulemaking; on the record voting; accurate minutes; rules against ex-parte communication; public meeting/disclosure/sunshine rules.
- A decision-making process subject to an excellent Administrative Procedures Act.
- Strong conflict of interest and revolving door statutes similar to those of the federal government to prevent undue insurance industry influence. If decision-making members of the NAIC have connections, past or present, to certain companies, the process will not be perceived as fair.
- Independent funding. The NAIC cannot serve as a regulatory entity if it relies on the industry for its funding. The bill should establish a system of state funding to the NAIC at a set percentage of premium so that all states and insured entities equally fund the NAIC.
- National Independent Advocate. To offset industry domination, an independent, national, public insurance counsel/ombudsman with necessary funding is needed. Consumers must be adequately represented in the process for the process to be accountable and credible.

<u>Regulation By Domiciliary States Will Lead to Unacceptably Weak Standards</u>

We oppose allowing a domiciliary state to essentially act as a national regulator by allowing domiciled companies to comply only with that state's standards. This approach has several potential problems, including:

- It promotes forum shopping. Companies would move from state to state to secure regulation from the state that has the least capacity to regulate, provoking a "race to the bottom."
- The state of domicile is often under the greatest political and economic pressure not to act to end harmful business practices by a powerful in-state company.
- The resources of states to properly regulate insurance vary widely.
- It is antithetical to states' rights to apply laws from other states to any business operating within their borders. If such a move is made, however, it is imperative that consumers have a national, independent advocate.
- It promotes a lack of consistency in regulation because companies could change domiciliary state status.
- Residents of one state cannot be adequately represented by the legislature/executive of another. If a resident's state consumer protections did not apply, the resident would be subject to laws of a state in which they have no representation. How can a consumer living in Colorado influence decisions made in Connecticut?
- Rather than focusing on protecting consumers, this system would change the focus to protecting itself and its regulatory turf, as has happened in the bank regulatory system. State and federal banking regulators have competed to lower their consumer protections to lure banks to their system.
- We would be particularly concerned with proposals to give exclusive control of market conduct exams to a domiciliary state. Unscheduled exams by a state are very important for that state's ability to protect its consumers from abuse. States must retain the ability to act quickly based on complaints or other information.

"One-Stop" Policy Approval Must Meet High Standards

Allowing insurers to get approval for their products from a single, unaccountable, non-state regulatory entity would also lead to extremely weak protections unless several conditions are met:

- An entity, such as the NAIC's Coordinated Advertising, Rate and Form Review Authority (CARFRA), that is not subject to authorizing legislation, due process standards, public accountability, prohibitions on ex-parte communications, and similar standards should not have the authority to determine which lines would be subject to one-stop approval process or develop national standards. It also must have funding through the states, not directly from insurers. Independent funding ensures that the regulatory entity is not subject to unfair and detrimental industry influence.
- Any standards that apply must be high and improve the ability of consumers to understand policies and compare on the basis of price. Consumers do not want "speed—to-market" for bad policies.
- Any entity that serves as national standard setter, reviewer and/or approver needs federal authorizing legislation. An "interstate compact" or "memorandum of understanding" is unworkable and unaccountable.
- Giving the regulated insurer the option to choose which entity regulates it is an invitation to a race to the bottom for regulatory standards.
- Standardization of forms by line has the potential to assist consumers if done in such a way to enhance understanding of terms, benefits, limitations and actual costs of policies.
- Public/consumer input is essential if the entity makes decisions that ultimately affect information provided to and rates charged consumers.
- We support the concept of an electronic central filing repository, but the public must have access to it.
- To retain oversight of policies and rates affecting their residents, states must have the ability to reject decisions of the entity.
- Any national system must include a national, externally funded consumer-public advocate/counsel to represent consumers in standard setting, development of forms, rate approval, etc.

Current Federal Proposals

Three major proposals have surfaced, two of which don't meet the basic standards of consumer protection cited above. Several trade associations have drafted legislation that would create an "optional federal charter" for insurance regulation, patterned on the nation's bifurcated federal/state bank chartering structure. In response, Senator Ernest Hollings last year introduced S. 1373, which would establish federal minimum standards for insurance regulation and repeal insurers' antitrust exemption under the McCarran Ferguson Act. Senator Hollings' goal was to prevent competition between state and federal regulators to lower standards. Most recently, Representatives Michael Oxley and

Richard Baker have circulated a discussion draft entitled the "State Modernization and Regulatory Transparency (SMART) Act." We will comment separately on each.

Optional Federal Insurance Charter

The bills that have been drafted by trade associations like the American Bankers Association and the American Council of Life Insurers would create a federal regulator that would have little, if any, authority to regulate price or product, regardless of how non-competitive the market for a particular line of insurance might be. Insurers would be able to choose whether to be regulated by this federal body or by state regulators. These bills represent the wish list of insurer interests, and include minimal, if any, regulation, coupled with little improvement in consumer information or protection systems.

Consumer organizations strongly oppose an optional federal charter, where the regulated, at its sole discretion, gets to pick its regulator. This is a prescription for regulatory arbitrage that can only undermine needed consumer protections. Indeed the drafters of such proposals have openly stated that this is their goal with the optional charter approach. If elements of the insurance industry truly want to obtain "speed to market" and other advantages through a federal regulator, let them propose a federal approach that does not allow insurers to run back to the states when regulation gets tougher. We could all debate the merits of that approach.

CFA and the entire consumer community stand ready to fight optional charters with all the strength we can muster.

The Insurance Consumer Protection Act of 2003, S. 1373

Only one bill currently before Congress considers the consumer perspective in its design, adopting many of the consumer protection standards cited in this testimony. That is S. 1373 by Senator Hollings. The bill would adopt a unitary federal regulatory system under which all interstate insurers would be regulated. Intrastate insurers would continue to be regulated by the states.

The bill's regulatory structure requires federal prior approval of prices to protect consumers, including some of the approval procedures (such as hearing requirements when prices change significantly) being used so effectively in California. It requires annual market conduct exams. It creates an office of consumer protection. It enhances competition by removing the antitrust protection insurers hide behind in ratemaking. It improves consumer information and creates a system of consumer feedback.

If federal regulation is to be considered, S.1373 should be the baseline for any debate on the subject before this Committee.

SMART Act

Rather than increase insurance consumer protections for individuals and small businesses while spurring states to increase the uniformity of insurance regulation, this sweeping proposal would override important state consumer protection laws, sanction anticompetitive practices by insurance companies and incite state regulators into a competition to further weaken insurance oversight. It is quite simply one of the most grievously flawed and one-sided pieces of legislation that we have ever seen with absolutely no protections offered for consumers. The consumers who will be harmed by it are our nation's most vulnerable: the oldest, the poorest and the sickest.

For example, the discussion draft would preempt state regulation of insurance rates. This would leave millions of consumers vulnerable to price gouging, as well as abusive and discriminatory insurance classification practices. It would also encourage a return to insurance redlining, as deregulation of prices would include the lifting of state controls on territorial line drawing. States would also be helpless to stop the misuse of risk classification information, such as credit scores, territorial data and the details of consumers' prior insurance history, for pricing purposes. The draft bill goes so far as to deregulate cartel-like organizations such as the Insurance Services Office and the National Council on Compensation Insurance, while leaving the federal antitrust exemption fully intact.

What the draft does not do is as revealing as what it does require. It does not create a federal office to represent consumer interests, although the draft creates two positions to represent insurer interests. It takes no steps to spur increased competition in the insurance industry, such as providing assistance or information to the millions of consumers who find it extremely difficult to comparison shop for this complex and expensive product, or eliminating the antitrust exemption that insurers currently enjoy under the McCarran-Ferguson Act. Insurers are not required to meet community reinvestment requirements, as banks are, to guarantee that insurance is available in underserved communities. Nothing is done to prevent insurers from using inappropriate information, such as credit scores or a person's income, to develop insurance rates.

CFA supports the goals outlined in several sections of this draft. As stated above, we are not opposed to increasing uniformity in insurance regulation. Unfortunately, however, in almost every circumstance in which the draft attempts to ensure uniformity, it chooses the weakest consumer protection approach possible. (For more details on CFA's concerns with this draft, please see the attached letter to House Financial Services leaders dated September 9, 2004.)

Federal Insurance Reform that Insurers Won't Discuss: Amending the McCarran Act to Provide Federal Oversight and, Perhaps, Minimum Standards for Efficient and Effective Regulation

Insurers want competition to set rates, they say. How about a simple repeal of the antitrust exemption in the McCarran Act to test their desire to compete under the same rules as normal American businesses do?

Another amendment to the McCarran Act we would suggest is to do what should have been done at the beginning of the delegation of authority to the states: have the FTC and other federal agencies perform scheduled oversight of the states' regulatory performance and propose minimum standards for effective and efficient consumer protection. The Hollings bill or relevant provisions of Proposition 103 in California might be the basis for such minimum standards.

Conclusion

CFA looks forward to working with the Committee to strengthen consumer protection for insurance consumers, Mr. Chairman. I will be happy to respond to questions at the appropriate time.

ATTACHMENT 1

Consumer Principles and Standards for Insurance Regulation

1. **Consumers should have access to timely and meaningful information about the costs, terms, risks and benefits of insurance policies.**

   - Meaningful disclosure prior to sale tailored for particular policies and written at the education level of the average consumer sufficient to educate and enable consumers to assess a particular policy and its value should be required for all insurance; it should be standardized by line to facilitate comparison shopping; it should include comparative prices, terms, conditions, limitations, exclusions, loss ratio expected, commissions/fees and information on seller (service and solvency); it should address non-English speaking or ESL populations.
   - Insurance departments should identify, based on inquiries and market conduct exams, populations that may need directed education efforts, e.g., seniors, low-income, low education.
   - Disclosure should be made appropriate for medium in which product is sold, e.g., in person, by telephone, on-line.
   - Loss ratios should be disclosed in such a way that consumers can compare them for similar policies in the market, e.g., a scale based on insurer filings developed by insurance regulators or an independent third party.
   - Non-term life insurance policies, e.g., those that build cash values, should include rate of return disclosure. This would provide consumers with a tool, analogous to the APR required in loan contracts, with which they could compare competing cash value policies. It would also help them in deciding whether to buy cash value policies.
   - A free look period should be required; with meaningful state guidelines to assess the appropriateness of a policy and value based on standards the state creates from data for similar policies.
   - Comparative data on insurers' complaint records, length of time to settle claims by size of claim, solvency information, and coverage ratings (e.g., policies should be ranked based on actuarial value so a consumer knows if comparing apples to apples) should be available to the public.
   - Significant changes at renewal must be clearly presented as warnings to consumers, e.g., changes in deductibles for wind loss.
   - Information on claims policy and filing process should be readily available to all consumers and included in policy information.
   - Sellers should determine and consumers should be informed of whether insurance coverage replaces or supplements already existing coverage to protect against over-insuring, e.g., life and credit.
   - Consumer Bill of Rights, tailored for each line, should accompany every policy.
   - Consumer feedback to the insurance department should be sought after every transaction (e.g., after policy sale, renewal, termination, claim denial). The insurer

should give the consumer notice of feedback procedure at the end of the transaction, e.g., form on-line or toll-free telephone number.

2. **Insurance policies should be designed to promote competition, facilitate comparison-shopping and provide meaningful and needed protection against loss.**

- Disclosure requirements above apply here as well and should be included in the design of policy and in the policy form approval process.
- Policies must be transparent and standardized so that true price competition can prevail. Components of the insurance policy must be clear to the consumer, e.g., the actual current and future cost, including commissions and penalties.
- Suitability or appropriateness rules should be in place and strictly enforced, particularly for investment/cash value policies. Companies must have clear standards for determining suitability and compliance mechanism. For example, sellers of variable life insurance are required to find that the sales that their representatives make are suitable for the buyers. Such a requirement should apply to all life insurance policies, particularly when replacement of a policy is at issue.
- "Junk" policies, including those that do not meet a minimum loss ratio, should be identified and prohibited. Low-value policies should be clearly identified and subject to a set of strictly enforced standards that ensure minimum value for consumers.
- Where policies are subject to reverse competition, special protections are needed against tie-ins, overpricing, e.g., action to limit credit insurance rates.

3. **All consumers should have access to adequate coverage and not be subject to unfair discrimination.**

- Where coverage is mandated by the state or required as part of another transaction/purchase by the private market (e.g., mortgage), regulatory intervention is appropriate to assure reasonable affordability and guarantee availability.
- Market reforms in the area of health insurance should include guaranteed issue and community rating and, where needed, subsidies to assure health care is affordable for all.
- Information sufficient to allow public determination of unfair discrimination must be available. Zip code data, rating classifications and underwriting guidelines, for example, should be reported to regulatory authorities for review and made public.
- Regulatory entities should conduct ongoing, aggressive market conduct reviews to assess whether unfair discrimination is present and to punish and remedy it if found, e.g., redlining reviews (analysis of market shares by census tracts or zip codes, analysis of questionable rating criteria such as credit rating), reviews of pricing methods, and reviews of all forms of underwriting instructions, including oral instructions to producers.
- Insurance companies should be required to invest in communities and market and sell policies to prevent or remedy availability problems in communities.

- Clear anti-discrimination standards must be enforced so that underwriting and pricing are not unfairly discriminatory. Prohibited criteria should include race, national origin, gender, marital status, sexual preference, income, language, religion, credit history, domestic violence, and, as feasible, age and disabilities. Underwriting and rating classes should be demonstrably related to risk and backed by a public, credible statistical analysis that proves the risk-related result.

4. All consumers should reap the benefits of technological changes in the marketplace that decrease prices and promote efficiency and convenience.

- Rules should be in place to protect against redlining and other forms of unfair discrimination via certain technologies, e.g., if companies only offer better rates, etc. online.
- Regulators should take steps to certify that online sellers of insurance are genuine, licensed entities and tailor consumer protection, UTPA, etc. to the technology to ensure consumers are protected to the same degree regardless of how and where they purchase policies.
- Regulators should develop rules/principles for e-commerce (or use those developed for other financial firms if appropriate and applicable.)
- In order to keep pace with changes and determine whether any specific regulatory action is needed, regulators should assess whether and to what extent technological changes are decreasing costs and what, if any, harm or benefits accrue to consumers.
- A regulatory entity, on its own or through delegation to an independent third party, should become the portal through which consumers go to find acceptable sites on the web. The standards for linking to acceptable insurer sites via the entity and the records of the insurers should be public; the sites should be verified/reviewed frequently and the data from the reviews also made public.

5. Consumers should have control over whether their personal information is shared with affiliates or third parties.

- Personal financial information should not be disclosed for purposes other than the one for which it is given unless the consumer provides prior written or other form of verifiable consent.
- Consumers should have access to the information held by the insurance company to make sure it is timely, accurate and complete. They should be periodically notified how they can obtain such information and how to correct errors.
- Consumers should not be denied policies or services because they refuse to share information (unless information is needed to complete the transaction).
- Consumers should have meaningful and timely notice of the company's privacy policy and their rights and how the company plans to use, collect and or disclose information about the consumer.
- Insurance companies should have a clear set of standards for maintaining the security of information and have methods to ensure compliance.

- Health information is particularly sensitive and, in addition to a strong opt-in, requires particularly tight control and use only by persons who need to see the information for the purpose for which the consumer has agreed to the sharing of the data.
- Protections should not be denied to beneficiaries and claimants because a policy is purchased by a commercial entity rather than by an individual (e.g., a worker should get privacy protection under workers' compensation).

6. **Consumers should have access to a meaningful redress mechanism when they suffer losses from fraud, deceptive practices or other violations; wrongdoers should be held accountable directly to consumers.**

- Aggrieved consumers must have the ability to hold insurers directly accountable for losses suffered due to their actions. UTPAs should provide private cause of action.
- Alternative Dispute Resolution clauses should be permitted and enforceable in consumer insurance contracts only if the ADR process is: 1) contractually mandated with non-binding results, 2) at the option of the insured/beneficiary with binding results, or 3) at the option of the insured/beneficiary with non-binding results.
- Bad faith causes of action must be available to consumers.
- When regulators engage in settlements on behalf of consumers, there should be an external, consumer advisory committee or other mechanism to assess fairness of settlement and any redress mechanism developed should be an independent, fair and neutral decision-maker.
- Private attorney general provisions should be included in insurance laws.
- There should be an independent agency that has as its mission to investigate and enforce deceptive and fraudulent practices by insurers, e.g., the reauthorization of FTC.

7. **Consumers should enjoy a regulatory structure that is accountable to the public, promotes competition, remedies market failures and abusive practices, preserves the financial soundness of the industry and protects policyholders' funds, and is responsive to the needs of consumers.**

- Insurance regulators must have a clear mission statement that includes as a primary goal the protection of consumers:
- The mission statement must declare basic fundamentals by line of insurance (such as whether the state relies on rate regulation or competition for pricing). Whichever approach is used, the statement must explain how it is accomplished. For instance, if competition is used, the state must post the review of competition (e.g., market shares, concentration by zone, etc.) to show that the market for the line is workably competitive, apply anti-trust laws, allow groups to form for the sole purpose of buying insurance, allow rebates so agents will compete, assure that price information is available from an independent source, etc. If regulation

is used, the process must be described, including access to proposed rates and other proposals for the public, intervention opportunities, etc.

- Consumer bills of rights should be crafted for each line of insurance and consumers should have easily accessible information about their rights.
- Regulators should focus on online monitoring and certification to protect against fraudulent companies.
- A department or division within the regulatory body should be established for education and outreach to consumers, including providing:
    - Interactive websites to collect from and disseminate information to consumers, including information about complaints, complaint ratios and consumer rights with regard to policies and claims.
    - Access to information sources should be user friendly.
    - Counseling services to assist consumers, e.g., with health insurance purchases, claims, etc. where needed should be established.
- Consumers should have access to a national, publicly available database on complaints against companies/sellers, i.e., the NAIC database. NAIC is implementing this.)
- To promote efficiency, centralized electronic filing and use of centralized filing data for information on rates for organizations making rate information available to consumers, e.g., help develop the information brokering business.
- Regulatory system should be subject to sunshine laws that require all regulatory actions to take place in public unless clearly warranted and specified criteria apply. Any insurer claim of trade secret status of data supplied to the regulatory entity must be subject to judicial review with the burden of proof on the insurer.
- Strong conflict of interest, code of ethics and anti-revolving door statutes are essential to protect the public.
- Election of insurance commissioners must be accompanied by a prohibition against industry financial support in such elections.
- Adequate and enforceable standards for training and education of sellers should be in place.
- The regulatory role should in no way, directly or indirectly, be delegated to the industry or its organizations.
- The guaranty fund system should be prefunded, national fund that protects policyholders against loss due to insolvency. It is recognized that a phase-in program is essential to implement this recommendation.
- Solvency regulation/investment rules should promote a safe and sound insurance system and protect policyholder funds, e.g., providing a rapid response to insolvency to protect against loss of assets/value.
- Laws and regulations should be up to date with and applicable to e-commerce.
- Antitrust laws should apply to the industry.
- A priority for insurance regulators should be to coordinate with other financial regulators to ensure consumer protection laws are in place and adequately enforced regardless of corporate structure or ownership of insurance entity. Insurance regulators should err on side of providing consumer protection even if regulatory jurisdiction is at issue. This should be stated mission/goal of recent changes brought about by GLB law.

- Obtain information/complaints about insurance sellers from other agencies and include in databases.

- A national system of "Consumer Alerts" should be established by the regulators, e.g., companies directed to inform consumers of significant trends of abuse such as race-based rates or life insurance churning.
- Market conduct exams should have standards that ensure compliance with consumer protection laws and be responsive to consumer complaints; exam standards should include agent licensing, training and sales/replacement activity; companies should be held responsible for training agents and monitoring agents with ultimate review/authority with the regulator. Market conduct standards should be part of an accreditation process.
- The regulatory structure must ensure accountability to the public it serves. For example, if consumers in state X have been harmed by an entity that is regulated by state Y, consumers would not be able to hold their regulators/legislators accountable to their needs and interests. To help ensure accountability, a national consumer advocate office with the ability to represent consumers before each insurance department is needed when national approaches to insurance regulation or "one-stop" approval processes are implemented.
- Insurance regulator should have standards in place to ensure mergers and acquisitions by insurance companies of other insurers or financial firms, or changes in the status of insurance companies (e.g., demutualization, non-profit to for-profit), meet the needs of consumers and communities.
- Penalties for violations must be updated to ensure they serve as incentives against violating consumer protections and should be indexed to inflation.

8. Consumers should be adequately represented in the regulatory process.

- Consumers should have representation before regulatory entities that is independent, external to regulatory structure and should be empowered to represent consumers before any administrative or legislative bodies. To the extent that there is national treatment of companies, a national partnership, or "one-stop" approval, there must be a national consumer advocate's office created to represent the consumers of all states before the national treatment state, the one-stop state or any other approving entity.
- Insurance departments should support public counsel or other external, independent consumer representation mechanisms before legislative, regulatory and NAIC bodies.
- Regulatory entities should have a well-established structure for ongoing dialogue with and meaningful input from consumers in the state, e.g., a consumer advisory committee. This is particularly true to ensure that the needs of certain populations in the state and the needs of changing technology are met.

ATTACHMENT 2

Consumer Federation of America

September 9, 2004

The Honorable Michael G. Oxley
Chair, Financial Services Committee
United State House of Representatives
Washington, DC 20515

The Honorable Barney Frank
Ranking Member, Financial Services Committee
United State House of Representatives
Washington, DC 20515

The Honorable Richard H. Baker
Chair, Subcommittee on Capital
Markets, Insurance and Government
Sponsored Enterprises
United State House of Representatives
Washington, DC 20515

The Honorable Paul E. Kanjorski
Ranking Member, Subcommittee on Capital
Markets, Insurance and Government
Sponsored Enterprises
United State House of Representatives
Washington, DC 20515

Re: "State Modernization and Regulatory Transparency Act" Draft Will Harm Consumers, Undermine Competition and Gut Insurance Regulation

Dear Representatives Oxley, Frank, Baker and Kanjorski:

Few issues that the Financial Services Committee will examine this year are as important to consumers as the dramatic restructuring of insurance regulation proposed in the discussion draft of the "State Modernization and Regulatory Transparency Act" (SMART). Insurance has become a fundamental and increasingly expensive commodity that Americans must purchase in order to own a home, drive a car or start a small business. Much needs to be done to broaden consumer protections and improve the current state-based approach to the regulation of insurance.

Rather than increase insurance consumer protections for individuals and small businesses while spurring states to increase the uniformity of insurance regulation, this sweeping proposal would override important state consumer protection laws, sanction anticompetitive practices by insurance companies and incite state regulators into a "race to the bottom" to further weaken insurance oversight. It is quite simply one of the most grievously flawed and one-sided pieces of legislation that we have ever seen; a veritable "wish list" of items requested by insurers with absolutely no protections offered for consumers. The consumers who will be harmed by it are our nation's most vulnerable: the oldest, the poorest and the sickest.

For example, the discussion draft would preempt state regulation of insurance rates. This would leave millions of consumers vulnerable to price gouging, as well as abusive and discriminatory insurance classification practices. It would also encourage a return to insurance redlining, as deregulation of prices would include the lifting of state controls on territorial line drawing. States would also be helpless to stop the misuse of risk classification information, such as credit scores, territorial data and the details of consumers' prior insurance history, for pricing purposes.

What the draft does not do is as revealing as what is does require. It does not create a federal office to represent consumer interests, although the draft creates two positions to represent insurer interests in Title XV. It takes no steps to spur increased competition in the insurance industry, such as providing assistance to the millions of consumers who find it extremely difficult to comparison shop for this complex and expensive product, or eliminating the antitrust exemption that insurers currently enjoy under the McCarran-Ferguson Act. Insurers are not required to meet community reinvestment requirements, as banks are, to guarantee that insurance is available in underserved communities. Nothing is done to prevent insurers from using inappropriate information, such as credit scores or a person's income, to develop insurance rates.

Since consumers foot the bill when regulatory inefficiencies exist, CFA is certainly not opposed to increasing uniformity in state insurance regulation -- as long as this involves the implementation of high consumer protection standards. In fact, CFA supports the goals outlined in several sections of this draft. Unfortunately, however, in almost every circumstance in which the draft attempts to ensure uniformity, it chooses the weakest consumer protection approach possible.

Our specific concerns with the draft include the following:

1. **State rate regulation would be preempted**. Most states review rate increases prior to their implementation today. Title XVI of the draft would eliminate this protection. For most lines of insurance, the draft would eliminate rate regulation after two years. During the two-year phase-in period, rates would be allowed to rise by 7 percent and 12 percent overall without state oversight, although rates for individual consumers would be able to rise by any amount. Elimination of rate regulation is harmful and undemocratic. It overrides decades of support for rate regulation by state legislators, and in some cases, the vote of the general public. Moreover, insurance is not a typical "product" and is not subject to normal competitive forces. Free market competition alone will not result in rates that are fair and affordable. Insurance policies are exceedingly complex legal documents. Most consumers can't look at an insurance policy and tell for sure whether it offers adequate coverage at a fair price. Comparison-shopping is very difficult because the amount, type and pricing of coverage can vary greatly. Moreover, once a policy is purchased, the real test of its effectiveness may not come for decades -- until a claim arises. Two examples of the failure of rate deregulation are the recent chaos in California's worker's compensation insurance market and in the Texas homeowner's insurance market. (For the many reasons why

insurance is not a normal product for the purposes of regulation, see the attached fact sheet.)

2. **States will also be blocked from preventing insurance abuses triggered by the misuse of classification information**. The deregulation of rates in the draft also deregulates the classification systems insurers use to price customers and policies. Classification systems are regulated by most states because insurers can maximize profits by denying older and sicker people health insurance or by denying inner city residents home and auto insurance. For example, most insurers use credit scoring for insurance rating, which segregates out poorer people for denial or for higher prices. Some insurers now want to use human genome data to price life insurance and Global Positioning Satellites to track consumers in order to price auto insurance. Regulation is required to control classification abuses – the number of potential "innovative" class systems that violate consumer rights and privacy is quite large. Information is also needed to police these abuses, such as zip code data to see where insurers are writing business and how much people are paying for insurance. Although states currently review these class systems to assure fairness and privacy protection, this draft would prohibit them from doing so in the future. Discrimination against people because of their income is not prohibited under the draft, so redlining and other unfair practices are sure to result.

3. **New anti-competitive practices would be sanctioned and encouraged.** Title XVI, Section 1601(c) of the draft deregulates insurance rating and advisory organizations, such as the Insurance Services Office and the National Council on Compensation Insurance. It applies the deregulation of rates and classifications to these organizations, including the two-year flex rating transition period. These organizations function as industry-wide cartels, colluding in the setting of rates or parts of rates, which they file on behalf of many insurance companies. The draft also keeps in place the anti-trust exemption that the insurance industry enjoys under the McCarran Ferguson Act, one of the few industry-wide antitrust exemptions allowed anywhere in federal law. In other words, this draft not only strengthens the ability of insurance executives and these cartel-like organizations to act in an anti-competitive manner, it ties the hands both of states that wish to examine these activities and of persons who are adversely impacted by what would be antitrust violations if it were not for the antitrust exemption. There can be no economic theory that justifies this total deregulation of insurance cartel behavior.

4. **The draft would prohibit any state from determining that competition for personal lines of insurance is not adequate, in order to hold rates in check.** In the wake of Hurricane Andrew, the State of Florida had to act to control price gouging. The draft would prohibit Florida or any state from taking the same steps in response to future natural disasters. Interestingly, Title XVI, section 1601 (g) of the draft does not deregulate medical malpractice insurance, presumably because the market is somewhat non-competitive today. Thus, the drafters are "a

little bit pregnant" on the issue of what to do in a non-competitive line of insurance. Doctors are protected from unjust rate increases in today's somewhat non-competitive market, but homeowners, auto owners and small businesses owners, who experience non-competitive markets every decade or so (due to the boom and bust insurance cycle) are not protected.

5. **Low and moderate-income consumers in assigned risk plans will be required to pay excessive rates.** Every state in the nation has created plans to offer insurance to persons unable to find insurance in the normal market. Auto and worker compensation plans (usually known as "assigned risk plans") and home insurance plans (called "FAIR plans") typically offer limited coverage at fairly high rates. Some states regulate rates in these insurance plans carefully, because they (or lenders) require consumers in many case to purchase this insurance and because studies have shown that most consumers placed in these plans are not there because of prior insurance losses, but for other reasons, such as where they live. Title XVI, section 1601 (b) of the draft actually requires that rates paid by consumers in assigned risk and FAIR plans be set at excessive levels, clearly violating current actuarial standards. The draft states that rates paid in these plans may not be less than "the entities' expected losses and expenses, including any net losses incurred in the previous period." Actuarial standards state that recoupment for past period losses is not appropriate in rate setting. The draft seems to not allow profits to be used in setting rates, only losses. It also does not allow the offsetting of insurer expenses by investment income, a standard actuarial practice. Participants in these residual market plans tend to be low income and minority persons who will be asked to pay insurance companies a guaranteed rate of profit using rates that will clearly be excessive. Such rates would be disapproved in many states if not for this ill-advised provision.

6. **The draft requires no representation of consumer interests.** Title XV, Section 1501 (i) of the draft creates two federal officials to act as advocates for the insurance companies, one before international bodies and another before federal agencies. On the other hand, the draft requires absolutely no representation for insurance consumers. The bill does not create an insurance consumer advocate's office to advocate on behalf of consumers before the states, the "Partnership," international bodies or federal agencies. It helps those who need no help -- insurers who can fund such activities and pass the costs on to their policyholders -- and ignores consumers who have very little representation and few resources. To add insult to injury, the only federal agency with extensive consumer protection expertise – the Federal Trade Commission -- is currently forbidden under federal law from even studying insurance issues without a Congressional request. The FTC should be empowered to review consumer issues related to insurance and a consumer advocate should be established to represent consumer interests before the Partnership and the states.

7. **Uniformity requirements insure that regulation of insurer practices is ineffective and weak.** Several sections of the bill would only allow the home

state of an insurer or a large commercial customer to oversee the practices of the insurer or the terms of the commercial policy. This is an extremely dangerous practice, as it is the home state where political pressure on regulators is often most intense. Frequently, former governors and other state officials serve on the boards of directors of such insurers and corporations. An insurer may offer few policies in their home state and many elsewhere. This practice could well provoke state competition to weaken insurance regulations and laws affecting large in-state companies, as states rush to appease companies with tremendous economic clout in their states or attract new companies. In other sections, the draft forces states to accept model laws once a majority of states have adopted these laws. This is a very bad idea. The insurance needs of consumers vary greatly from state to state. Urban states have a very different set of issues than rural states, but rural states will set the standards under these "majority rules" provisions, essentially eliminating any effective legislative capacity for many of the nation's largest states.

8. **Insurers are allowed to choose whether to comply with new life insurance regulations.** In Title V of the draft, life insurers are allowed to file new products at a single point for clearance in multiple states. This could be beneficial to all consumers if all insurers participated and the best experts from the states were used to apply rigorous standards to review products. However, the draft sets up a regulatory "race to the bottom" by allowing insurers to opt out of the multi-state approach at will and return to state-by-state regulation. Insurers should not be allowed to play regulators off each other in order to achieve the weakest possible oversight.

9. **Enforcement of federally mandated uniform standards is vague and unclear.** The drafters of this proposal claim that they are not creating a new federal regulatory body. Instead, they have created a "Partnership" in Title XV of three insurance commissioners, three federal officials and a chair nominated by the state commissioners and selected by the President. The Partnership could take a state to federal court for not complying with the draft's provisions, but it is unclear what the penalty would be if a state refused to comply. For instance, in 1989, Californians voted down the state's system of deregulated insurance rates – the very same system that this draft requires -- in favor of strict regulation. This regulatory regime has proven to be the most effective in the nation (see CFA's comprehensive study of the California system, "Why Not the Best?" at http://www.consumerfed.org/whynotthebest.pdf). Why would the Insurance Commissioner of California willingly agree to be subject to the inadequate protections of this bill when he knows that the current state-based system works well for his constituents?

There is no doubt that some sections of this draft could benefit consumers if consumer protection standards were high, and multi-state enforcement was excellent. These include the anti-fraud provisions in Title X, the single point of filing for life insurance products in Title V and the market conduct requirements in Title II. However, overall this draft is an extraordinary step back for insurance consumers. Rather than "modernize" insurance regulation, this draft would re-open the door to some of the worst insurance abuses of the past, such as cartel pricing and redlining, and tie the hands of states that attempt to stop abusive insurance practices and unfair and disparate pricing. We strongly urge of the drafters of this proposal to return to the drawing board, this time with the needs of consumers and small business owners in mind.

Sincerely,

J. Robert Hunter

Travis B. Plunkett
Legislative Director

J. Robert Hunter
Director of Insurance

CC:
Members of the House Financial Services Committee
Members of the Senate Banking Committee

WHY INSURANCE IS AN ESSENTIAL PUBLIC GOOD, NOT SOME NORMAL PRODUCT THAT CAN BE REGULATED SOLELY THROUGH COMPETITION

1. ***Complex Legal Document***. Most products are able to be viewed, tested, "tires kicked" and so on. Insurance policies, however, are difficult for consumers to read and understand -- even more difficult than documents for most other financial products. For example, consumers often think they are buying insurance, only to find they bought a list of exclusions.

2. ***Comparison Shopping is Difficult***. Consumers must first understand what is in the policy to compare prices.

3. ***Policy Lag Time***. Consumers pay a significant amount for a piece of paper that contains specific promises regarding actions that might be taken far into the future. The test of an insurance policy's usefulness may not arise for decades, when a claim arises.

4. ***Determining Service Quality is Very Difficult***. Consumers must determine service quality at the time of purchase, but the level of service offered by insurers is usually unknown at the time a policy is bought. Some states have complaint ratio data that help consumers make purchase decisions, and the NAIC has made a national database available that should help, but service is not an easy factor to assess.

5. ***Financial Soundness is Hard to Assess***. Consumers must determine the financial solidity of the insurance company. One can get information from A.M. Best and other rating agencies, but this is also complex information to obtain and decipher.

6. ***Pricing is Dismayingly Complex***. Some insurers have many tiers of prices for similar consumers—as many as 25 tiers in some cases. Consumers also face an array of classifications that can number in the thousands of slots. Online assistance may help consumers understand some of these distinctions, but the final price is determined only when the consumer actually applies and full underwriting is conducted. At that point, the consumer might be quoted a much different rate than he or she expected. Frequently, consumers receive a higher rate, even after accepting a quote from an agent.

7. ***Underwriting Denial***. After all that, underwriting may result in the consumer being turned away.

8. ***Mandated Purchase***. Government or lending institutions often require insurance. Consumers who must buy insurance do not constitute a "free-market", but a captive market ripe for arbitrary insurance pricing. The demand is inelastic.

9. ***Incentives for Rampant Adverse Selection***. Insurer profit can be maximized by refusing to insure classes of business (e.g., redlining) or by charging regressive prices.

10. ***Antitrust Exemption***. Insurance is largely exempt from antitrust law under the provisions of the McCarran-Ferguson Act.

Compare shopping for insurance with shopping for a can of peas. When you shop for peas, you see the product and the unit price. All the choices are before you on the same shelf. At the checkout counter, no one asks where you live and then denies you the right to make a purchase. You can taste the quality as soon as you get home and it doesn't matter if the pea company goes broke or provides poor service. If you don't like peas at all, you need not buy any. By contrast, the complexity of insurance products and pricing structures makes it difficult for consumers to comparison shop. Unlike peas, which are a discretionary product, consumers absolutely require insurance products, whether as a condition of a mortgage, as a result of mandatory insurance laws, or simply to protect their home or health.