Consumer Federation of America

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TESTIMONY OF

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BEFORE

UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

REGARDING

REGULATORY MODERNIZATION: PERSPECTIVES ON INSURANCE

JULY 28, 2009

Good morning Chairman Dodd, Ranking Member Shelby and members of the committee. My name is Travis Plunkett, and I am the legislative director for the Consumer Federation of America (CFA).[1] Thank you for inviting me here today to discuss perspectives on modernizing insurance regulation. Our insurance director, Bob Hunter, wanted to be here today but could not because he is taking care of a sick family member.

CFA Is Reviewing Its Policy Positions on State and Federal Insurance Regulation

CFA is nearing the end of a detailed review of our policy positions on insurance regulation, taking into consideration the lessons we are learning from the economic meltdown. We are also reviewing the problems with and successes of state regulation that occurred before the current crisis erupted. We expect to have the review completed shortly and will present our findings to date in this testimony.

I can report to you today that some issues are settled in our minds, including the need for an expanded role for the federal government generally in regulating insurance and protecting insurance consumers.

WHAT THE FEDERAL GOVERNMENT SHOULD CONSIDER REGULATING

Our review shows that there is systemic risk in insurance, requiring a federal systemic risk regulator. In order to fully understand and control systemic risk, we believe that the federal government should take over solvency/prudential regulation of insurance. We have reached this conclusion even in light of the fact that, looking backward, a strong case can be made that the states have done a good job in solvency regulation of insurers in recent years. Looking forward, however, we see that a single solvency/prudential regulator with national systemic risk as part of its portfolio is required to eliminate any potential national systemic risk. Therefore, Congress should consider the following actions:

1. There are significant systemic risk issues associated with certain lines of insurance. Congress should consider creation of a systemic risk regulator for insurance.

2. In order to properly oversee insurer financial condition, CFA believes that the federal government should be the solvency/prudential risk regulator for all insurers. This federal oversight office would also be a mechanism to monitor any systemic risk. It is difficult to understand how a systemic regulator could function properly without the sort of understanding gained from total solvency/prudential analysis.

3. A federal office, similar to the Office of National Insurance proposed by the President, should be a repository of insurance expertise, data collection[2] and analysis, and should

[1] CFA is a non-profit association of over 280 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy, and education.

[2] The federal government should require insurers to report HMDA-style market performance data. The same type of salutary effects HMDA has brought to the mortgage market could happen with insurance. State regulators and state

also engage in international insurance issues. While a federal insurance office should be knowledgeable about insurance matters to help Congress and the Administration sort through the tremendous complexities of this industry, the office should not be granted vague and open-ended powers of preemption regarding state consumer protection laws or rules in areas that Congress has chosen not to explicitly preempt.

4. A federal consumer protection agency with jurisdiction over credit markets should be granted authority to put minimum standards on the books regarding credit-related insurance transactions. The Consumer Financial Protection Agency should also be authorized to study insurance matters that are important to consumers and appear before the states or the courts on behalf of consumers on issues regarding personal lines of insurance, i.e., homeowners and automobile insurance.

WHAT THE FEDERAL GOVERNMENT SHOULD NOT CONSIDER REGULATING

The states are well established in insurance regulation with great expertise and experience. States regulate over 7,000 insurers using over 10,000 staff working on insurance matters, spending well over a billion dollars a year on the effort. CFA has cited many weaknesses in state insurance regulation but there are some functions we find that the states perform that the federal government cannot match. In particular, these tasks relate to dealing directly with insurance consumers. States handle almost a half million complaints and an additional 3 million requests for information. Several states average more insurance inquiries and complaints than the entire federal banking system does. The Federal Reserve Board (the Fed) and the Office of the Comptroller of the Currency (OCC), combined, only handled about 130,000 calls and written complaints for the entire nation, which is less than the number of inquiries that states like California, Florida and Texas handle on insurance. Our recent study of state web sites found that many states provided quite good information for consumers, and that state websites are consistently improving.[3] While many states perform inadequately in regulating insurance rates and forms and in market conduct examinations (litigation uncovers much more that really hurts consumers than the states do), we believe that, with some notable exceptions, there has been less gouging in state-regulated insurance pricing than in, for example, credit card, mortgage lending and other federally regulated lender practices.

The states, being nearer to the people, seem to be more responsive to consumer needs. Here is what we think the federal government should not be tasked with doing:

1. While CFA supports a greater federal insurance role in several targeted areas, we vigorously oppose an optional federal charter (OFC), since such a system cannot control

legislatures have shown themselves unable or unwilling to provide consumers with any meaningful market performance data. Despite insurers using credit scores for close to 15 years in insurance, there is not one state insurance department that collects any data to monitor the impact of insurance scores on the availability or affordability of insurance – even during the current severe economic downturn. The availability of these data would create much greater transparency of the job performance of insurance regulators and would enable the public to gain market power needed to create more competitive insurance markets.

[3] "State Insurance Department Websites: A Consumer Assessment," Consumer Federation of America, November 10, 2008, http://www.consumerfed.org/pdfs/state_insurance_websites.pdf.

systemic risk, has failed miserably in protecting banking consumers and sets up pressures that can only lead to reduced consumer protections through regulatory arbitrage.

2. Consumer protection is often best accomplished at a government regulatory level close to the people. We, therefore, believe that the states should continue to handle consumer protection regulation at this time. Such regulation must address all key consumer issues, such as claims abuses, unfair risk classification criteria, the unavailability of needed insurance, complaints and requests for information on insurers, prices and other information. In order to properly accomplish consumer protection, any emerging regulatory system must contain, among other things, the capacity to regulate rates (including classifications) and policy forms. Our study of decades of auto insurance data from all states proves that tough, balanced regulation, including rate regulation, is most effective in protecting consumers. Such a system also works well for insurers and enhances competition in the states with tough regulation.

3. As detailed below, we do think it is necessary for a new federal consumer protection agency to be able to set minimum standards only for lines of insurance that are closely linked to (or would not exist without) credit transactions. Credit-related insurance lines include title, mortgage, credit and creditor-placed home insurance. These lines are unique because the coverage is typically selected not by the consumer but by a third party, such as a lender, real estate agency, car dealer, or closing attorney. The entity selecting the insurance usually receives compensation from the insurer (such as commissions, free or below-cost services, and other payments), leading the selection of the insurance to focus on the size of such payments, which drives up premiums paid by borrowers in a process that has become known as "reverse competition." These types of insurance are typically a very poor value for consumers and have generally been weakly regulated by the states.

OTHER IMPORTANT STEPS CONGRESS SHOULD CONSIDER

1. Repeal of the antitrust exemption in the McCarran-Ferguson Act must be part of any efforts by Congress to reform insurance regulation. Collusion in the pricing of property/casualty insurance should not be allowed in the 21st century. CFA endorses H.R. 1583, the "Insurance Industry Competition Act of 2009," introduced by Rep. Peter DeFazio.

2. As Congress considers creating an Office of National Insurance with knowledge about insurance, it should also either restore the ability of the FTC to study insurance or, if a Consumer Financial Protection Agency is created, grant this authority to the new agency. This would allow the federal government to assist the states in identifying consumer protection issues that have national ramifications.

After responding to the questions you raised in your letter of invitation, Mr. Chairman, I will briefly discuss each of these conclusions and then I will highlight the CFA research on the future of insurance regulation that is nearing completion.

KEY QUESTIONS ON REGULATORY MODERNIZATION OF INSURANCE

1. There is a wide spectrum of options with regard to how or whether the federal government should oversee insurance. What are the basic options and the pros and cons of each?

The range of options extends from the status quo to a full federal takeover of insurance regulation. Many of the options are discussed in the following testimony. A listing of advantages and disadvantages of federal vs. state regulation is in the testimony that follows. We conclude that it is not as simple as the states or the federal government being the sole regulator, so the status quo or a full federal takeover, the end points of the spectrum of options, should be rejected. The states have better experience and staffing, are better able to provide information and greater access for individual consumers. The federal government is better at dealing with bigger issues, national trends, and international and systemic issues. An optional charter approach, where the insurer chooses a regulator, is inherently dangerous for consumers, impossible to use for systemic risk regulation, and would create an unacceptable regulatory arbitrage situation. We conclude that some combination of state and federal oversight other than an OFC is required. The general regulatory division that best deals with the strengths and weaknesses of each level of government is to have the federal government deal with systemic risk, solvency and international issues but to have the states deal with consumer protection, complaints and market conduct issues. (An exception would be granting the new Consumer Financial Protection Agency minimum standards authority over credit-related insurance transactions.)

I should point out that neither the federal or state regulatory systems have distinguished themselves recently. The Federal government has failed to adequately deal with both financial and market regulation (e.g., no action on predatory lending, attempts to usurp state efforts to control it, and failure to adequately monitor the financial condition of many institutions).

The federal government's involvement in insurance has also been grossly negligent. For instance, the National Flood Insurance Program that I once administered has failed to do the sort of loss mitigation or stop building in uninsurable areas that it was intended to do. Flood maps are antiquated and the Write Your Own Program is inefficient, all leading to huge taxpayer subsidies of unwise construction and poor insurance administration. Another example is ERISA health insurance where consumer requests for help often go unheeded.

As to the states' performance – by and large, all substantive regulation is done either by the biggest states – New York, Florida, Texas, and California[4] or through National Association of Insurance Commissioner (NAIC) models. State insurance regulators have a weak record of consumer protection and a long history of being captured by the industry they regulate.

It appeared to us that the various multi-state accreditation programs had provided greatly improved consistency of financial regulation across states. It also appeared that states had incentives to maintain strong financial solvency regulation for domestic insurers, so that insurers would not fail. Recent events have proved us wrong.

[4] These four states account for about half of the staff and financial resources used nationally to regulate insurance.

In 2008, the life insurance industry approached NAIC officers. In secret meetings, the NAIC decided to fast-track several significant accounting and reserve practices; rules for how much money insurers must have readily available for paying claims. The proposed changes would have, in our opinion, weakened the financial condition of insurers, while maintaining the appearance of a strong financial condition. The changes would have reduced the amount of money insurers needed to hold in reserve, or allowed non-liquid assets to be counted as the capital cushion to protect consumers in the event reserves were inadequate. After strong opposition from consumer groups, the NAIC voted not to adopt these changes, stating that the industry had not made the case the changes were needed. However, a dozen individual states started allowing "permitted practices," which were state exceptions to accounting rules that resulted in the creation of billions of dollars of capital or reserves. The states that allowed these exceptions were responding to political pressure from domestic insurers. This debacle laid bare the problem with state-based financial regulation.

As for market conduct regulation, the states have a poor record. Some states at some times have done well for consumers, but states as a group routinely fail to identify market problems or proactively protect consumers.

2. Should the Federal Government collect information on the insurance industry to start building a knowledge base?

Absolutely. The federal government needs to know how insurance works, what the systemic risks are, how consumers are treated, what the national macro trends in insurance are and such information. HMDA-type information is critically needed to protect low-income and minority consumers of insurance. Both the proposed Office of National Insurance and the Consumer Financial Protection Agency should be allowed to collect information and study various insurance issues, with the CFPA focusing on issues of special importance to individual consumers and small businesses.

3. Should the Federal Government monitor insurance as a part of systemic risk oversight?

Yes. First, Congress should consider re-imposing restrictions similar to those of the Glass-Steagall Act, so insurers are not engaged in risky non-insurance practices.

Second, whether systemic risk exists depends on the type of insurer. Bond insurers and mortgage guaranty insurers have shown themselves to be able to wreak havoc on the bond and mortgage markets. One aspect of this problem is the small number of such insurers and the high market concentration of just a few insurers. One approach would simply be to limit the market share of any insurer to, say, 10 percent of the market to avoid the failure of a single insurer bringing down an entire market.

Title insurers also may pose systemic risk. Two companies hold over two-thirds of the national market and the failure of one or both of these insurers could be catastrophic. Title insurance policies would become void and there is no guaranty fund system in the vast majority of states. Banks require title on mortgages, so there could be havoc in the mortgage markets.

Life insurers, by virtue of their holdings of financial assets and investments, might also pose systemic risk.

Property/casualty insurers, other than bond, private mortgage, and title insurance, have little systemic risk, but there is risk from a weak guaranty fund system and from reinsurance, in a combination of extreme loss events. A pre-funded federal guaranty fund system, modeled after FDIC, would be much superior to the current state-based system.

The best way to avoid systemic risk is not through a systemic regulator. The best approach is to limit the activities and size of insurers to avoid any danger of systemic risk. However, a systemic risk regulator would be needed to accomplish the identification of size and activity risk and is therefore part of the solvency/prudential regulator we suggest be created.

4. Does the difference in accounting for insurers (statutory accounting) versus other financial services institutions (GAAP) pose a difficulty in how the federal government can assess an insurer's financial health?

No. There are relatively simple crosswalks between SAP and GAAP that the federal government can use to understand the strength of an insurer. Insurers could be required to report both ways in any event. Publicly traded insurers report their financials both ways already.

5. Is federal resolution authority needed for insurance holding companies? If so, how should it interact with the current state regulator and guaranty fund resolution powers?

If Congress creates or designates a separate systemic risk regulator and houses the resolution authority in that entity, then that entity would need to have authority to demand corrective actions if an insurer is, in their view, taking on undue risks. In that case, should they simply supersede state regulatory authority or should they seek to work with state regulators? We think the systemic risk regulator has to have ultimate authority in such cases, particularly given the lack of independence of so many state insurance regulators.

You could, for example, encourage the systemic risk regulator to work with the state regulator to implement corrective actions, but give the systemic risk regulator ultimate authority to act should state regulators prove uncooperative or ineffective. Congress could also encourage the systemic risk regulator to communicate any concerns about emerging risks to state regulators in order to enhance state regulators' ability to police companies for risky conduct before it becomes a problem that results in a failure that requires resolution.

Later in the testimony we show that state guaranty funds have serious problems and could fail if one or more large insurers failed. Surely companies that are too large to fail should not be handled through the state guaranty funds but should be handled by a federal resolution authority. Such a determination should not be made at the point of failure, however, since any company subject to federal resolution should also be subject to federal corrective action authority. If the federal systemic risk regulator has authority to conduct broad surveillance of the insurance industry, then that regulator should be given authority to determine when a particular company

would be subject to federal resolution authority. This is why systemic risk regulation should not be separated from solvency/prudential risk regulation.

If Congress decides to create a systemic risk panel, instead of giving this authority to a single regulator, then state insurance regulators would presumably be part of that panel. If they were, they could help to make the determinations with regard to resolution authority. Whether state regulators would be inclined to try to retain maximum authority or to dump as much as possible onto the federal regulator is an important question. Based on their behavior in recent years, it likely that the states would fight to retain their "turf." Congress should study just what are the implications of such a state approach, which is another reason why we are inclined to support a single federal systemic risk/solvency/prudential regulator.

If Congress creates a federal insurance regulator, then that regulator would presumably work with the systemic risk regulator/resolution authority in the same way that would federal banking and securities regulators. Again, the agency that bears the responsibility for resolution should have the authority to require corrective actions.

If Congress puts resolution authority in one place (for example, with the FDIC) and systemic risk regulation authority in another, there would obviously need to be coordination between these two agencies. There is a potential for problems if the two agencies disagree about the nature or extent of any risks and the need for corrective actions. This may be an argument for keeping these two functions together in the same agency. On the other hand, there also is a case for giving resolution authority to the FDIC, which already has expertise in that area.

6. Is there a need for a Federal regulator of insurance? Who should determine which insurers should be regulated at the Federal level?

We believe that the situation in the nation has reached a point where the federal role in insurance regulation must be increased. Our position is that the federal government should regulate all insurers for systemic/solvency/prudential risk and international issues, with the states generally regulating market conduct and consumer protection matters, as discussed in detail in this testimony. A federal Consumer Financial Protection Agency should have authority to set minimum standards for credit-related insurance products.

7. Do certain insurance products or companies impact the national economy? If so, how should they be regulated?

Yes, as detailed elsewhere in this testimony. Imagine a situation where insurers refuse to write insurance because of economic damage or other issues. Hazard insurance on the coasts of America are an example. There, insurance is not available at affordable prices so states have had to create pools and take on risks themselves. Doctors march on state capitals when the economic cycle of insurers cause periodic price spikes for medical malpractice insurance. What if bond insurers fail? What if guarantee associations fail? All of these pose significant risks that impact millions of Americans and can undermine the nation's economy. As a Presidential commission once noted, "Communities without insurance are communities without hope."[5] Insurance has

[5] "National Advisory Panel on Insurance in Riot-affected Areas," 1968.

become a necessity, not an option. States require it, lenders require it, and people and businesses cannot function without insurance protection. Insurance has taken on a role not unlike a public utility, essential to grease the wheels of our economy.

Systemic Risk and Insurance

In the past year, the government has stepped in to bail out or otherwise rescue a number of financial institutions not backed by an explicit federal guaranty, from Bear Stearns, to Fannie Mae and Freddie Mac, to AIG. The government's decision not to bail out Lehman Brothers is blamed by many for the sudden freezing of global credit markets last fall and the precipitous stock market decline that ultimately convinced Congress to put hundreds of billions of dollars of taxpayer money on the line to prevent a broader financial collapse. This chain of events has prompted a nearly universal call for improved systemic risk regulation as an essential component of any regulatory reform package.

The fact that one of the institutions rescued, AIG, is a major insurance firm and the fact that some insurers have lobbied to receive rescue funds, puts insurers in the middle of that debate. As a result, decisions about how best to regulate insurance must take into account issues related to systemic risk. The decisions Congress makes about how to regulate systemic risk could, in turn, have implications for other types of insurance regulation issues, particularly the issue of whether a federal insurance regulator is needed.

Some in the insurance community have argued – correctly, to a degree[6] – that it was not AIG's insurance activity that created the systemic risk that prompted its rescue. Instead, it was AIG's ties to other financial institutions through hundreds of billions of dollars in unregulated credit default swaps that caused the government to conclude that a failure at AIG would have devastating consequences for the global financial system. Many observers have concluded that, although there are some very large insurers, their failure would be unlikely to pose a comparable systemic risk. Although there would doubtless be temporary market disruptions from such a failure, the existence of numerous competitors ready to step in and assume the coverage they provided would mitigate the risk to consumers. The existence of state guaranty funds is also cited as a factor that limits the systemic risk associated with an insurance company failure. Finally, state insurance regulators have been quick to note that capital standards, reserve requirements, and investment limitations imposed on insurers to guaranty their ability to pay claims have protected them from taking on the excessive risks that have proved so troubling for their colleagues in commercial and investment banking.

Although there is some validity to these arguments, they have their limitations. It is ironic, for example, that state regulators are boasting in Congress about the effectiveness of their capital and reserve requirements in stabilizing insurers even as several states act quietly at the individual state level to massively loosen those requirements to make their domestic life insurers look better on their 2008 balance sheets. Meanwhile, the state guaranty funds may create the illusion of safety where it does not exist. While the funds <u>might</u> be able to absorb the failure of a single large insurer, it is almost certain that they would not be able to handle the simultaneous

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[6] It appears that some $21 billion in losses in the AIG life insurers "securities lending program" did occur and was the basis for some federal taxpayer-backed relief.

failure of several large insurers in a timely fashion.[7] Moreover, there are other specialized insurers, most notably the bond insurers, whose role in the financial markets has clear systemic implications. The credit downgrade of bond insurers last year spilled over into the credit default swap market in ways that contributed to the freezing of credit markets. Current concerns with Directors and Officers Insurance for banks, where prices have doubled and the availability of insurance are questionable for some banks, may threaten to undermine bank recovery. Clearly, enough insurance-related systemic risk potential exists for insurers to be included in any plan to enhance systemic risk regulation.

Although proposals on how to regulate to mitigate systemic risk are just taking shape, it appears likely that systemic risk will consist of at least three components:

1. Efforts to better monitor the financial system for the build-up of risks that could have systemic implications;

2. Standard-setting to reduce the risk of failure at a large or otherwise systemically significant institution; and

3. Creation of a mechanism to allow the orderly failure of non-bank financial institutions similar to the power the Federal Deposit Insurance Corporation (FDIC) currently has with regard to banks. Many have further suggested that a systemic risk regulator also needs FDIC-like authority to intervene in troubled financial institutions before a crisis to force them to take corrective actions to head off a threatened failure.

As Congress moves to provide for enhanced regulatory focus on systemic risk, insurers are clearly among the financial institutions that should expect to have their activities monitored. Beyond that, however, the issues for insurance regulation become more complicated. The following are among the key issues that need to be resolved:

1. What authority should a federal systemic risk regulator have to restrict conduct by insurers that it views as posing a systemic risk?

CFA believes the ability to monitor for risks without the ability to act to constrain those risks is meaningless. Whether this authority is accomplished through preemption of state solvency regulation, as some have suggested, will depend in part on the model of systemic risk regulation that Congress adopts. Should Congress decide to designate a single, central systemic risk regulator, it is likely to give that regulator authority at a minimum to override any state or federal risk-related regulations, such as capital and liquidity standards, that it believes are insufficiently rigorous to protect against a risk to the financial system. It could go further, authorizing the systemic risk regulator to directly set such standards for institutions or practices deemed to be systemically significant, a category that would almost certainly include some insurers, or to intervene at such institutions to demand corrective actions under certain circumstances.

[7] CFA has grave doubts about the Guaranty Funds and even think they might present some systemic risk, as discussed below.

On the other hand, should Congress adopt a model of systemic risk regulation in which a "college" of financial regulators, presumably an expanded and refocused version of the Presidential Working Group on Financial Market Stability, works together to monitor systemic risk, actions to constrain those risks are likely to be carried out through the existing regulatory entities. State insurance regulators could reasonably expect to play a direct role in that coordinating council. Even under this latter model, however, state securities regulators could find themselves under intense pressure to act according to federal directives regarding systemic risk. The difference is that they are likely to have a more active role in developing those policies. To the degree that state insurance regulators want to be taken seriously as partners in the effort to constrain systemic risks, they would strengthen their case if they would call an immediate halt to state-level measures designed to loosen industry capital and reserve requirements being pushed by insurers who are reluctant to acknowledge the shakiness of their finances at a time of economic crisis. They also need to reform the National Association of Insurance Commissioners (NAIC), which acts more like a trade organization than a regulator, with ex-parte meetings, secret meetings, no freedom of information requirements, no limits on leaving NAIC office and immediately start lobbying for the regulated entities and other such failings (discussed in greater detail below).

2. Will all insurers be affected by federal systemic risk regulation or only the largest, most "systemically significant" insurers?

Here again, the degree of intrusiveness of federal systemic risk regulation into the insurance industry will depend on the model of regulation Congress chooses to adopt. Some have suggested designating certain institutions as "systemically significant" and subjecting them to heightened regulatory standards to prevent them from taking on excessive risks. Because only a small number of insurers would likely be designated as systemically significant, this approach would likely require the least federal intrusion into insurance regulation, even though that role could be extensive with regard to that small number of systemically significant insurers. This view is based on a too-narrow focus on preventing the failure of large institutions. To be effective, systemic risk regulation must focus not just on risks within large institutions, but also on risks in smaller institutions or in particular markets with the potential to infect the broader market. Also, the use of reinsurance to spread risk around the world can also have systemic impacts on the primary insurance markets should one or more large reinsurers fail.

Moreover, CFA shares the views of those who have argued that designating institutions as "systemically significant" is unworkable. Decisions about where to draw the line would be hopelessly arbitrary. Systemic risk is likely to be determined by an interaction of various factors, including at a minimum size[8], the nature of activities engaged in, and degree of interconnection with the financial markets as a whole. Even if you could set a meaningful dividing line based on these various factors, it would require constant adjustments based on changing market conditions and constant monitoring of institutions on the borderline. A far more logical approach is to monitor all, or nearly all, financial institutions and to impose capital standards on those institutions that ratchet up significantly as the institution takes on more risk – either by growing

[8] This determination would have to be made for entire groups of insurance companies, not individual members of the group, since reinsurance and other cooperative arrangements within groups often share risk across the corporate enterprise.

to a size that makes it "too big to fail," by engaging in risky activities, or by entering into risky relationships with other players in the broader financial markets. Such a model is likely to affect a far broader segment of the insurer population and, in doing so, prompt a debate about the need to preempt state standards. This is part of the reason why CFA now believes that solvency/prudential regulation should be handled by the federal government in the future.

Another approach that would lessen the possible systemic impact of insurance is simply to restrict insurance companies to the business of insurance and prohibit companies or conglomerates from mixing insurance with credit, investment banking and other financial services (i.e., repeal part of the Gramm Leach Bliley Act). Standing alone as pure insurers, most insurers have little systemic risk.

3. Would large insurers be subject to a federal system for the orderly failure of non-financial institutions or do state guaranty funds suffice to fill that role for the insurance industry?

One of the misconceptions about systemic risk regulation is that its intent is to protect large financial institutions from failure. CFA is convinced that the possibility of failure must be restored in order to provide accountability for assuming excessive risks. To accomplish that goal, a key focus of systemic risk regulation must be on creating a mechanism to allow the orderly unwinding of large non-bank financial institutions comparable to the authority the FDIC already has with regard to banks. After all, it was the absence of such a mechanism that forced the government to improvise in devising its rescue strategies.

The question for the insurance industry is whether insurers would be covered by such a mechanism or whether they would continue to rely on state guaranty funds to serve this function. CFA has grave concerns about the adequacy of state guaranty funds, particularly with regard to their ability to handle the simultaneous failure of several large insurers. At a minimum, large insurers facing failure would be expected to rely on a federal mechanism and therefore should be expected to contribute to its funding, assuming it is to be funded through some form of insurance premium. An alternative approach, and one that would be clearer in its applicability, would be to expand access to the program to a larger population and to impose premiums based on the degree of risk posed by those institutions. If the program included regulatory authority to intervene in advance of a crisis to force corrective actions, insurers could expect greater federal involvement in certain types of regulatory issues.

CFA's concerns with the state guaranty associations are that the associations, being post-assessment plans in nearly every case (New York is the exception), are very vulnerable to a large failure. It is very possible that the system could be overwhelmed by a series of large failures and stop functioning to promptly restore policyholders and claimants to their pre-insolvency position in a timely way.[9]

The guaranty associations can assess for claims beyond the ability of a failed insurer. They do this by assessing the remaining, solvent insurers. So today, with several life insurers in

[9] Some will argue that the system could tolerate a large failure, but even they will admit to do so would require freezing funds for quite a long time, likely bringing knock-on impacts to the economy.

some trouble, a string of failures would put a call for money on other already stressed insurers. To ease this problem, these assessments for money are capped at various percentages of premiums from the last (or recent) year(s) and that would mean that, once the limits on assessments are exceeded, claims and demands for money from an insured's account could not be fully paid. So the risk is not just that the system taps insurers at a time of weakness, but that insureds, including individuals and businesses, might not be able to collect the money they need to get back to normal activity, adversely impacting the recovery of a stressed economy. Thus, the guaranty associations have a degree of systemic risk built into their structure.

Let's focus on life insurance -- currently more at risk of seeing failures (beyond AIG) than the property/casualty industry. In 2007, life insurance premiums were $142.7 billion and annuities premiums were $314.6 billion. (Property/casualty insurance premiums were $452.4 billion in 2007.)[10]

If failures happen, the national capacity for life insurance is limited by two factors in a state: the way assessments are limited and the way accounts are set up in the state.

Assessment limits vary. In most states, it is two percent of premiums from the previous year.[11] But there are exceptions. In Alabama, for example it is one percent of premiums from the previous year. In California, it is one percent of the average of the premiums for the prior three years. In Connecticut it is two percent of the average premiums over the last three years. It would be reasonable to estimate the national assessment capacity at two percent of the latest year premium.[12]

The second limit on assessment is the state account structures that divide the life insurance premiums into various categories. For instance, Alabama has three accounts, life insurance, disability insurance and annuities.[13] Florida breaks it down as health, life and annuity. Sometimes life and annuity are combined in one account.

It is safe to say that the national assessment capacity is far less than $9.1 billion (this figure is calculated as two percent of the total of life and annuity premiums from 2007). This is a very high estimate of potential money available to help in the situation of life insurer and annuity insurer insolvencies in the first year because: (1) the premiums from the pre-funded state of New York are included; (2) two percent is more than would be achieved on average as discussed above; (3) some states split life and annuity into separate funds, further minimizing the available funds, and (4) the available premiums for assessment would drop because the amount of

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[10] Life and annuity premiums from ACLI's "Life Insurance Fact Book," 2008 and P/C premiums from Best's "Aggregates and Averages," 2008. Health insurance premiums written by life insurers were $151.5 billion, excluding Blue Cross/Shield and HMOs and some health insurance written by P/C insurers. I should note that New York is a pre-funded plan, but over the years money has been taken out of the fund by the government for other purposes and replaced by an IOU.

[11] State-by- state data are available at www.nolhga.com/factsandfigures/main.cfm/location/lawdetail/docid/16.

[12] In fact, this estimate is somewhat high as some states have a one percent assessment cap and others use averages, which, since premiums are growing, are lower than simple use of the latest year.

[13] The Account Structure information on a state-by-state basis is found at www.nolhga.com/factsandfigures/main.cfm/location/lawdetail/docid/1.

premium of the insurers that become insolvent (or appeal the assessment because of being in fragile solvency condition) being removed from the calculation.

Less than $9 billion would not go far should even one major insolvency involving a deep "hole" (shortfall) occur. Heck, it would hardly cover AIG's bonuses and parties! Insureds would be unable to get their money out of the funds, perhaps for years. Some claims would not be fully paid (even without the insolvency funds melting down, there are limits on what these funds pay out – usually in the range of $100,000 to $300,000 per policy) perhaps for many years, if ever, in the case of a series of insolvencies.

CFA believes enhanced systemic risk enforcement is an essential component of regulatory reform and that the focus should be broad. As such, we believe it is both inevitable and appropriate that insurers be brought under a system of systemic risk regulation. Because issues of systemic risk regulation are directly relevant to the broader policy debate over insurance regulation, these two issues cannot easily be divorced. We would note, however, that those who have sought to use the focus on systemic risk regulation to argue for an optional federal charter have the issue exactly backwards. Whatever else it is, systemic risk regulation is not optional. For systemic risk regulation to be effective, the regulator must have broad authority to determine the scope and extent of their authority. Moreover, if we have learned nothing else from the current crisis, we should have learned that giving financial institutions the ability to choose their regulator seriously undermines the quality of oversight and the rigor of regulation. That, in turn, has the potential to create serious systemic risks.

4. What potential systemic risks might insurers pose to the nation?

Congress should study the potential systemic risk of bond insurance, title insurance, mortgage guarantee insurance and reinsurance. Reinsurance and retrocession spread risk around the world in ways that normally lower risk but could, in certain circumstances, cause massive failure if a series of major impacts were to be felt at once (i.e., a "black swan" could cause great failure worldwide if reinsurance failed to deliver in its secondary market function). Major storms, earthquakes, terrorism attacks and other catastrophes could occur at about the same time that might bankrupt some of these significantly inter-connected secondary-market systems, for instance.

Currently, banks are paying double last year's rates for directors and officers' coverage, if they can get it at all. If the degree of unavailability grows, Congress should study just what are the systemic implications if banks cannot hire officers or get directors to serve due to the lack of D&O coverage. Would the recovery of a bank be retarded by the flight of directors and officers from the institution if no insurance protection was available to protect them from shareholder or consumer suits?

Some state regulators themselves have recently introduced an element of systemic risk because of their willingness to cut consumer protections for life insurance by slashing reserves and other dollars of policyholder cushion at this time of great risk. Their theory seems to be that when consumers do not need to worry about the soundness of insurers they will keep high cushions of protection, but when policyholders most need this protection, they will change

accounting standards at the request of insurers. Several states have lowered capital and reserve requirements for life insurers despite the fact that the NAIC ultimately refused to do so. NAIC acknowledged that it had not done the due diligence necessary to determine if the proposed changes would weaken insurers excessively. (See Attachment 2 for the detailed comments I made prior to the NAIC action to not adopt the ACLI proposals.)[14]

In summary, CFA has come to a number of conclusions about the proper role of systemic risk regulation of insurance:

1. Insurance should be covered by any systemic risk regulatory structure that Congress develops.
2. Systemic risk regulation of insurance must include monitoring and enforcement components that are mandatory for insurers, not optional. An optional approach to systemic risk will fail.
3. Systemic risk regulation of insurance should take into consideration bond insurance, title insurance, the possible impact on other financial sectors of the unavailability or un-affordability of certain lines of coverage (such as the emerging difficulties for banks in obtaining Directors and Officers Insurance), reinsurance, where very large risks are shared among many insurers, post-assessment guaranty funds and possibly other insurance risks.
4. Dividing the insurance industry into "systemically significant" and non-significant companies is not feasible. Instead, the regulator should monitor all, or nearly all, insurers to impose capital standards on those institutions that ratchet up significantly as the institution takes on more risk – either by growing to a size that makes it "too big to fail," by engaging in risky activities, or by entering into risky relationships with other players in the broader financial markets.
5. Regulation for solvency/prudential regulation should be moved over to federal control in order to properly understand and control risk.
6. Congress should consider taking several steps that would lower the overall systemic risk of the insurance industry, including repealing the provisions of the Gramm-Leach-Bliley Act that allow firms to sell insurance in conjunction with other financial services, particularly credit and securities products.
7. Eliminating post-assessment guaranty funds could also lower insurance systemic risk and replacing them by state directed, nationally based, pre-assessment funds, or by a federal insurance guaranty agency modeled on the FDIC. We favor a federal guaranty system based on the FDIC approach.

The Consumer Financial Protection Agency (CFPA) and Insurance

We strongly support the CFPA legislation proposed by the Administration that would give the new agency jurisdiction over four credit-related insurance products: credit insurance, title insurance, mortgage insurance, and mortgage guarantee insurance, also known as private mortgage insurance since it is a form of credit insurance. (See Attachment 3 for a description of the various types of credit insurance.) All of these products are sold in connection with a credit transaction and are intertwined with loans. For this reason, we believe the CFPA should have the

[14] See Attachment 2.

same authority over these products that it has over other credit-related financial products.

The states have generally done a very poor job of protecting consumers of credit-related insurance products. These are products sold in connection with a consumer loan and have often been part of the arsenal used by predatory lenders. For example, the Departments of Housing and Urban Development and Treasury found in 2000 that the sale and financing of single premium credit insurance was "unfair, abusive, and deceptive….."[15] Importantly, it has not been the states that have been at the forefront of efforts to limit or stop lenders' use of financed single premium credit insurance for mortgage or consumer loans.

Under the legislation, the agency would not have jurisdiction over either investment-type products, such as annuities, or other personal insurance products, such as personal auto, residential property, and other consumer property and casualty insurance products. In general, CFA believes this is the appropriate division of responsibility, with three exceptions:

- Creditor-placed (also known as "forced place") insurance, which is a form of credit-related insurance that often involves policies that are significantly overpriced and third-parties that provide kickbacks to the banks, should be covered by the CFPA.

- To prevent regulatory arbitrage, products that are similar to credit insurance, such as debt cancellation contracts sold by banks, should also be regulated by the CFPA. From a consumer's perspective, they are equivalent products, but they are regulated differently because federal banking regulators have declared them to be banking products. (For additional information on these products, see Attachment 4.)

- The CFPA should have the authority to advocate for and represent consumers of personal insurance products (such as auto or homeowners and other property insurance) before the state insurance regulators and in the courts. Some have said that this consumer advocacy authority should rest with the proposed new Insurance Office within the Department of Treasury, but CFA believes consumer advocacy is better placed in CFPA, an agency whose mission is to protect consumers.

Problems for Consumers Buying Insurance Products Related to Lending Transactions

Reverse Competition Hurts Consumers: The dominant characteristic of insurance markets related to credit transactions throughout the country is *reverse competition.* The consumer who pays for the product does not select the insurer; rather, the parties receiving compensation for the insurance select the insurer. For example, an insurer might sell a credit insurance group policy to a lender. The lender then sells the credit insurance to the borrower on behalf of the credit insurer and issues a certificate of insurance under the group policy to the borrower. This market structure leads insurers to bid for the lender's business by providing higher commissions and other compensation to the lender. As a result, greater competition for the lender's business leads to higher, often unfair prices of credit insurance to the borrower. In fact, CFA's Director of Insurance, J. Robert Hunter, was once at a credit insurance hearing in

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[15] Available at http://www.huduser.org/publications/pdf/treasrpt.pdf, page 7.

Virginia at which Prudential was asked why they wrote so little credit insurance in the state. The Prudential witness said they were non-competitive because their rates were "too low." The same sort of system holds in title insurance and mortgage guarantee insurance, which are covered under the President's plan, and forced-place insurance, which is not.

In addition to raising prices, reverse competition also harms consumers by limiting consumer choice, often to products that offer little real value to consumers. This results from the fact that, in a reverse-competitive market, the consumer is unable to effectively exert normal competitive pressure on the original seller of the product. In credit insurance, mortgage guarantee insurance, title and forced place insurance (but not mortgage insurance), the lender is almost always involved in the selection of the insurer, while the ultimate consumer – the borrower – is effectively limited to accepting or rejecting the package offered. If a consumer purchases a product and finances the purchase at one store or auto dealer, he or she cannot decide to go elsewhere to purchase the credit-related insurance for that loan. There is no marketplace for the insurance separate from the lender financing the purchase. As a result, lenders are able to dictate the terms of the credit insurance sale, determining what coverages will be offered, for example. Because the credit-related insurance transaction is typically a minor aspect (to the borrower) of a larger transaction – the loan to purchase a car, jewelry or furniture – consumers are willing to go along, particularly if they believe they must or are strongly encouraged to purchase the credit-related insurance to get the financing to buy the product they want.

As a result of this market dynamic, lenders rather than borrowers are the primary beneficiaries of credit-related insurance sales. First, the lender's loan is protected against events that impair the borrower's ability to repay. With credit-related insurance in place, the lender need not incur any costs to force payment from the surviving spouse or relative of a deceased borrower or from a borrower who has become disabled or unemployed. Second, the lender often gets substantial commission and other revenue from the insurance premium. Commissions and other compensation are typically 40 percent or more of the premium.

Consumers, on the other hand, often obtain little if any benefit. The best measure of overall value of credit insurance to consumers is the loss ratio – the ratio of benefits paid on behalf of the consumer to the premiums paid by consumers. Consumer groups have advocated regulation to ensure that consumers receive a loss ratio of at least 60 percent, meaning that, on average, at least 60 percent of the premiums paid by borrowers should be ultimately paid out in claim benefits on behalf of borrowers.

The chart below shows consumers have received poor value from the main types of credit insurance coverage for many years. The low loss ratios for credit unemployment are particularly disturbing. The amount of overcharges for just these three types of credit insurance is in the billions of dollars.

	Credit Life Premium ($M)	Loss Ratio	Credit Disability Premium ($ Millions)	Loss Ratio	Credit Unemploy-ment Premium ($ M)	Loss Ratio
1999	2,255	41.5%	2,457	44.2%	1,143	7.6%
2000	2,206	40.8%	2,374	46.4%	1,108	6.0%
2001	2,243	40.9%	2,382	50.0%	1,077	8.8%
2002	2,110	41.4%	2,199	49.3%	911	13.7%
2003	1,857	42.9%	1,933	47.2%	727	13.5%
2004	1,624	43.1%	1,797	46.9%	551	9.6%
2005	1,559	41.3%	1,679	40.4%	477	10.4%
2006	1,442	43.1%	1,570	39.4%	431	8.1%
2007	1,348	42.8%	1,514	36.8%	395	14.2%
2008	1,257	44.0%	1,410	38.3%	383	13.1%

Some states do much better than the average, but some states do much worse than the average. In 2008, the best and worst states for these coverages were:

2008		Credit Life Loss Ratio		Credit Disability Loss Ratio		Credit Unemployment Loss Ratio
Worst	NV	24.6%	SD	20.7%	AR	0.0%
2nd Worst	LA	27.4%	NV	22.8%	MI	0.0%
2nd Best	RI	67.3%	VT	66.0%	PA	33.2%
Best	ME	69.8%	ME	72.8%	VA	39.7%

One of the worst examples of the failure of state regulators to protect credit insurance consumers is a coverage called credit family leave, which is supposed to make monthly payments on the consumer's loan in the event the consumer goes on an approved family leave. In the five years since data has been collected for this product, the loss ratio has been almost zero: about 2 (two) dollars in benefits paid for every $1,000 dollars of premium collected. Consumer groups have alerted insurance regulators to these egregious results since 2005, yet regulators continue to allow insurers to sell a worthless product, a product which insurers told regulators would pay out at least 50 cents on the dollar in benefits.

	Family Credit Leave Premium	Claims Paid	Family Credit Leave Loss Ratio
2004	$50,396,018	$82,163	0.2%
2005	$39,851,001	$93,388	0.2%
2006	$29,179,076	$63,975	0.2%
2007	$25,486,677	$55,849	0.2%
2008	$22,508,468	$52,978	0.2%
	$144,912,772	$295,375	0.2%

State regulators have also done a poor job with creditor-placed insurance, which lenders purchase for and charge to the borrower in the event the borrower does not maintain the required auto or property insurance for the vehicle or property loan. This type of insurance is big business: over $600 million in creditor-placed auto and almost $2 billion in creditor-placed property insurance. The loss ratios in 2007 and 2008 have been dismal, in the low 20s.

	Creditor Placed Auto		Creditor Place Home		Credit Personal Property	
	Premium (Millions)	Loss Ratio	Premium (Billions)	Loss Ratio	Premium (Millions)	Loss Ratio
2007	$500,	24.3%	$1.402	20.5%	$183	14.2%
2008	$628,	21.2%	$1.991	23.2%	$328	7.8%

These creditor-placed premiums are inflated by commissions paid to lenders and by other unreasonable expenses, which state regulators have endorsed instead of limiting. Lenders get a commission or other forms of compensation that create a significant profit center from virtually every force-placed policy, despite the fact that the policy is being placed to protect the lender. Moreover, the premium often includes expenses for tracking consumer loans to ensure insurance is in place, including for the borrowers that are not forced-placed and would never be, because their insurance is paid out of escrow. Thus, two to three percent of the borrowers who are forced-placed pay for the escrow tracking for 100 percent of the lender's portfolio.

Title insurance loss ratios are truly dismal. Over the 20 years prior to 2007, title insurance paid out benefits averaging 6.1 percent of premium. Over the decade prior to 2007, the number dropped to 4.9 percent.[16] In 2008, the loss ratio "jumped" to 11.7 percent.[17]

In summary, state regulation of credit-related insurance products has, for most consumers, failed to protect them from unreasonable prices and practices. There is great variation among the states, with some states doing a good job on some products, but most states doing a poor job on most products.

[16] Source: "U.S. Title – 2007 Market Review, A. M. Best Special Report," October 13, 2008, Page 4.

[17] Missouri Department of Insurance, Financial Institutions and Professional Regulation, at http://www.insurance.mo.gov/reports/lossratio

The special interests determination to hold off reform at any cost has proven highly effective. For these reasons, we believe America's consumers need CFPA to cover credit-related insurance products.

The agency should study credit-related insurance products to determine exactly what actions are needed to protect consumers from the ravages of reverse competition. The agency should, for example, be involved in the process of rate regulation by the states, advocating before the states for minimum loss ratios consistent with fair consumer value. The agency should also be advocating for states to develop real (as opposed to reverse) competition in these lines of insurance and should develop ideas for accomplishing this. Possible approaches might include: educating consumers about their rights to shop for alternative sources of coverage; breaking up the cartel-like control over information about who needs such insurance so that other providers of coverage could contact consumers in time to compete for the sale; and abolishing the kickback arrangements that leave low-priced competitors unable to sell their products.

The agency should seek to learn from those firms that are struggling to break down the walls with lower prices, but who are thwarted by the cartel relationships and big kickbacks, and from other agencies that have been successful in adopting reforms. Iowa, for example, succeeded in reforming the market for title insurance, and other nations have also apparently broken the cartel-like arrangements. These examples, and systems such as Torrens[18] rather than title insurance, should be reviewed for possible use in this country.

Can Solvency Regulation be Separated from Consumer Protection Regulation?

Insurers argue that splitting solvency regulation from consumer protection regulation would be dangerous since consumer protection regulation would include regulation of rates so that the rate regulator, not being involved in solvency regulation, would have no pressure to keep rates adequate. We disagree.

First of all, our extensive search of large insolvencies over the decades has not found one insolvency in insurance history directly attributable to rate regulation. Congress has not found such effects either, to our knowledge.[19] Secondly, our research into the best systems of auto insurance regulation found conclusive evidence that the state with the best consumer results, California, had the toughest rate regulation producing the lowest rate changes in the nation but with very healthy insurer profits (and with the fourth most competitive auto insurance market in the nation as well). Third, any new system Congress develops will require close coordination between the federal regulator and the state regulators, at least through a lengthy transition period. No state would fail to respond to the federal regulator's call for a review of a situation that might be problematic from a solvency point of view. In fact, federal control of solvency would allow a national perspective on insurance trends that would help in controlling risk of solvency. One of the few times insurers might under price is at the end of the so-called "soft market" in the "cycle" of insurance profits. Property/casualty insurance profits are cyclical and the pattern typically is several years, around 8 to 10 years, of a soft market where prices are flat to down, followed by a short, 2 to 3 year hard market, where prices spike. A national solvency regulator

18 Torrens is a system of registration of land titles that makes title insurance unnecessary.

[19] See, e.g., "Failed Promises," House Commerce Committee, 1990.

would, for the first time, have the data and national focus to be ahead of the cycle and could alert states to upcoming price trends and conditions, thus easing the cycle's impact.

In short, there are simply no major, irresolvable issues stemming from splitting solvency from consumer protection when regulating insurance.

Consumers Do Not Care about the Locus of Regulation, but Care a Great Deal about the Quality and Effectiveness of Consumer Protections. (From CFA's Ongoing Study of Insurance Regulation and the Impact of the Financial Meltdown On the Prospects for State or Federal Regulation.)

A) What is better, state or federal regulation of insurance?

There are certain regulatory functions that the states can do better than the federal government, and other functions that could potentially be more effective at the federal level. For example, it is very likely that a federal complaint handling system would not be as consumer-friendly as is the present state system. Contrarily, a state system would likely not approach the effectiveness of a federal system when it comes to systemic risk identification and control.

Here is a chart of some major areas comparing state and federal system capacities:

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	Some States
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
Efficient solvency regulation?	No	Yes*
Effective guaranty in event of insolvency?	Yes	No
Adequately restricts revolving door between regulators and industry?	Maybe	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 data processing capacity?	Yes	No
Systemic risk analysis and control	Yes	No
Web page information excellence	Maybe	Yes

* Jury is still out on this issue as the economy falters and some states lower capital standards for life insurance.

This sort of chart provides several indications of how to change the current insurance regulatory system to make it more effective. For instance, the states have more experience, are more responsive to local needs and better at handling complaints, and may be better at solvency monitoring than federal agencies. This argues for a role for the states in dealing with consumers' needs at the ground level. However, the federal government is likely to be better at the very

important big issues of assessing macro-trends that cross state borders, as well as determining and controlling systemic risk. This argues for federal oversight of national risks.

These differential capacities thus may suggest some sort of hybrid approach that allows states to deal with local issues and the federal government to deal with over-arching issues that might impact the nation, such as bond insurance and other systemic risks cited above. The state expertise might also imply a strong role in the overall decision-making process once the federal systemic regulator identifies macro trends.

The chart may also support differential treatment of property/casualty insurers, where local issues such as weather catastrophes and legal requirements (e.g., no-fault vs. tort for auto) are vital matters for regulation, whereas the life insurance market is more national in scope and may lend itself to federal regulatory requirements.

I should warn you, as I am sure you already know Mr. Chairman, to beware of insurers seeking to help you create their "new" regulatory system. 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 about seven years ago, 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. In other words, the industry killed the federal insurance office they now covet. 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 its selection of a preferred regulator. They always favor the least regulation. It is not surprising that, the industry would again seek a federal role at a time (seven years ago) when they perceived 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. Thus an "O" is added to their preferred approach, the "OFC" – the Optional Federal Charter. And, even though the federal government now seems more intent

on regulating as a result of the economic lessons of late, the industry can still support an OFC since they do not have to opt for a federal regulator now if they choose against it.

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 seven years. Insurers have repeatedly warned states that the only way to preserve their control over insurance regulation is to weaken consumer protections.[20]

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 to weaken consumer protections.

Unfortunately for consumers, the strategy has paid off. In the last few years, the NAIC has moved to sharply cut consumer protections adopted over a period of decades. The NAIC is terrified of Congressional action and sees reducing state consumer protections as the way to "save" state regulation by placating insurance companies and encouraging them to stay in the fold. This strategy of saving the village by burning it has made state regulation more, not less vulnerable to a federal takeover.

The NAIC has also failed to act in the face of a number of serious problems facing consumers in the insurance market.

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[20] 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 the tide. In a July 9, 2001, *Wall Street Journal* article by Chris Oster, Mattera admitted his intent was to get a "headline or two to get people refocused." No commissioner challenged Mattera and many commissioners went so far as to beg industry representatives 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." As a result, 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 *National Underwriter* 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…"

In the NAIC meeting of June 2006, Neil Alldredge of the National Association of Mutual Insurance Companies pointed out "states are making progress with rate deregulation reforms. In the past four years, 16 states have enacted various price deregulation reforms…(but) change is not happening quickly enough…He concluded that the U.S. Congress is interested in insurance regulatory modernization and the insurance industry will continue to educate Congress about the slow pace of change in the states (Minutes of the NAIC/Industry Liaison Committee, June 10, 2006)."

NAIC Failures to Act

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 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 call for repeal of the antitrust exemption in the McCarran-Ferguson Act as they push forward deregulation model bills. Indeed, the NAIC still opposes repeal of the antitrust exemption even as they deregulate…effectively seeking to deregulate cartel-like organizations.

5. 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.

6. Failure to end use of occupation and education in underwriting and pricing of auto insurance.[21]

7. 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 limits purchased by the applicant, prior insurer, prior non-standard insurer, education, occupation, not-at-fault claims, not to mention use of genetic information, where Congress has had to recently act to fill the regulatory void.

8. Failure to heed calls from consumer leaders to do something about contingency commissions for decades (until Attorney General Spitzer finally acted).

9. Failure to even discover, much less deal with, the claims abuses relating to the use of systems designed to systematically underpay claims for millions of Americans.

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[21] Florida has held hearings on the practice.

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

11. 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.

12. Failure to take meaningful action on conflict-of-interest restrictions even after Ernest Csiszar left his post as South Carolina regulator and President of the NAIC in September 2004 to become President of the Property Casualty Insurers Association of America after negotiating deregulation provisions in the SMART Act desired by PCIAA members. Other recent NAIC presidents took similar lobbying and other jobs in the industry and about half of all commissioners come from and return to their industry perches.

13. Failure to act to create regional catastrophic pools to spread hurricane risks or to effectively deal with inappropriate short-term, unscientific models which have sharply raised consumers' home insurance prices along the coasts.

NAIC Rollbacks of Consumer Protections

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.

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

3. NAIC has 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.

4. NAIC almost cut the safety of life insurance capital and surplus cushions protecting consumers, but relented at the last minute after it became obvious that the basic research on whether this was wise and would not lead to insurer failure was not finished. After the NAIC acknowledged that this was not ready for action, many states proceeded to implement the very same changes anyway, sharply weakening consumer protection in the face of the mounting danger of insurer failure.

B) CFA's research into best regulatory systems in the states: Why competition alone does not control unfair classes or hold down price increases, and why price regulation is necessary in insurance.

In April 2008, CFA released a detailed, national study of automobile insurance regulation over the last two decades that found that rates have risen more slowly in the fifteen states that require insurers to receive advance approval of rate increases from the state.[22] States with "prior approval" regulation also performed well in spurring competition and generating reasonable profits for insurers. The top-performing state in keeping rates down and providing comprehensive consumer protections was California. Among the worst performing states were those with weak or no regulation of rates at all. These states had the steepest rate increases, less competitive markets and among the highest profits for insurers.

The study assessed automobile insurance regulation in all 50 states and the District of Columbia. It examined a number of factors that are important to consumers and insurers, including rate increases from 1989 through 2005, insurer profits from 1997 through 2005, as measured by return on net worth, and the current level of competition.

The chart below shows the results for each of these factors for the six different systems that states use to oversee insurance rates. With the exception of the one state that mandates the rates insurers can charge, the fifteen states that require insurers to receive approval for rate changes before they go into effect had the smallest increase in rates (54 percent) from 1989 through 2005. In fact, column 3 shows that the weaker the regulatory system, the greater the price increase consumers have faced. States with a prior approval regime also had a similar level of competition and slightly lower, but reasonable, insurer profits compared to states with different forms of regulation. According to the widely used Herfindahl-Hirshman Index (HHI), states with prior approval rules have insurance markets that are on the border between competitive and moderately concentrated. The states that provided the lowest level of consumer protection used the regulatory system known as "Competition," in which the state has no authority to control rates. These states had sharper rate increases, higher profits and greater market concentration than all other regulatory systems other than the one state that set prices for insurers.

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[22] "State Automobile Insurance Regulation: A National Quality Assessment and In-depth Review of California's Uniquely Effective Regulatory System," April 2008, at http://www.consumerfed.org/pdfs/state_auto_insurance_report.pdf.

PRIVATE PASSENGER AUTO INSURANCE

Column 1	Column 2	Column 3	Column 4	Column 5
Regulatory System	**Number of States Using the System**	**1989/2005 Change in Expenditure**	**1997/2005 Return on Net Worth**	**HHI Index**
State Set	1	52.8%	6.4%	1371
Prior Approval	15	54.0%	8.6%	984
File & Use	23	68.1%	9.0%	1016
Use & File	8	70.0%	9.7%	935
Flexible	2	70.8%	7.0%	1292
Competition	2	73.9%	9.6%	1111

State Set: state establishes rates insurers can charge.
Prior Approval: insurers cannot put rate changes into effect without state approval.
File and Use: rate changes can take effect without state approval, but must be filed with the state before use and can be later disapproved.
Use and File: rate changes can go into effect without state approval but must be filed after use and can be later disapproved.
Flexible: rate changes can be filed and used without approval unless they change by more than a particular amount, when filing and approval are required.
Competition: state has no authority to control rates.

California's regulatory system, which was adopted by state residents when they voted for Proposition 103 in 1988, performed well in virtually every category examined by the report, including all of the factors cited above. Two exceptions were insurer profit levels over the longer term (1989 through 2006), which were somewhat high, and a large population of uninsured motorists. The California system's positive results for consumers include the following:

- Generated estimated savings of $61.8 billion for consumers over the sixteen years that Proposition 103 has been in effect;
- First among all states in holding down rate increases (to 12.9 percent);
- Fourth in market competitiveness as measured by the HHI (716);
- The only state to totally repeal its antitrust exemption for automobile insurers;
- The only state to put reasonable limits on expenses passed through to consumers, such as fines and excessive executive salaries;
- Has a very low number of residents participating in higher cost "assigned risk" insurance plans;
- Among the eleven states with the highest ranking from the Insurance Institute for Highway Safety for strong seat belt laws;
- One of only four states that guarantees that good drivers can receive a policy that can be renewed from an insurer of their choosing;

- The only state to require that a person's driving record is the most important factor in determining insurance rates, followed by the number of miles driven and years of driving experience. All other factors used by insurers must have less impact on rates than these criteria;
- One of only three states to ban the use of credit scoring for setting rates or granting coverage;
- The only state to require that insurers offer consumers the lowest price available from all of the companies in the insurer group;
- The only state that funds consumer participation in the ratemaking process if a substantial contribution is made. [23]

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.[24] We question the entire foundation behind the

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[23] "State Automobile Insurance Regulation: A National Quality Assessment and In-Depth Review of California's Uniquely Effective Regulatory System," April 2008, http://www.consumerfed.org/pdfs/state_auto_insurance_report.pdf.

[24] 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.

assumption that virtually no front-end regulation of insurance rates and terms coupled with more back-end (market conduct) regulation is better for consumers. First of all, there are many reasons why competition in insurance is weak (see below). The track record of market conduct regulation has been extremely poor in most states. 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 guaranty, such beneficial price competition.

Front-end regulation should be designed to prevent market conduct problems from occurring. 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.

The insurance industry promotes a myth: that 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. They do very successfully, as we have documented in California under the pro-competitive but tough regulatory system created by the adoption of Proposition 103 by the people of that state.

- 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.

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.

Insurance cannot be effectively regulated by competition alone. There are several key reasons for this truth:

1. ***Insurance is a 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.

It is clear that regulation and competition, working together, produce the most effective results in insurance. Price regulation, particularly when markets are stressed, as in the cities for auto insurance and the coasts for home insurance, is essential in protecting consumers. A critical aspect of price regulation, one that is often overlooked and never disclosed by proponents of no price regulation, is that classifications are part of price in insurance. Classes must be regulated since they can be arbitrary, unfair, discriminatory and not based on any factor relating to the risk being insured, thereby undermining one of insurance's most vital social benefits, incentive for risk reduction. If an insurer decided to use race as a class, existing regulations would stop it. However, most states allow insurers to use a number of classifications that are proxies for race and income that have a very negative impact on lower income and minority consumers. For example, many auto insurers today use a combination of credit scores (exposing the poor and unemployed to higher rates, education (more education results in lower rates), occupation (higher paying jobs equal lower rates, unemployment means very high charges), limits of bodily injury insurance with the previous insurer (high limits means lower prices, if you buy only the minimum level that the state requires you pay more, a penalty for obeying the law), homeownership (yes means lower prices). Classes, and therefore prices, must be regulated.

C) CFA favors creation of a federal insurance office, with caveats.

The President and several key members of Congress have called for the creation of a federal insurance office.[25] When our insurance director, Bob Hunter, was Federal Insurance Administrator, he was in charge of several statutory programs, the most important of which was the National Flood Insurance Program (NFIP). The White House also charged FIA with studying insurance and helping other federal agencies with insurance issues. The agency worked on national no-fault auto insurance with the Department of Transportation, national health insurance with the Department of Health and Human Resources, risk retention proposals with several agencies and workers' compensation insurance with the Commerce Department, for example.

The insurance industry, which now seeks to create such an office, successfully urged President Reagan to kill the work other than that mandated by statute, thus assuring that the federal government had no insight into one of the most important industries in the nation. Interestingly, at about the same time, the industry lobbied Congress and the Administration to

[25] The President recently proposed the creation of an Office of National Insurance within the Department of the Treasury in his regulatory restructuring "White Paper." Such an office was first proposed by Representative Paul Kanjorski last year. (The bill number for this Congress is H.R. 2609.)

take away FTC's ability to study insurance, further handicapping Washington's capacity to understand insurance.

At a time when systemic risk is an obvious danger, when losses due to natural catastrophes have caused severe dislocations in some states, where international terrorism is an ever-present threat, and consumers are coping with a diverse array of insurance problems, including some problems (like the unavailability and un-affordability of Directors & Officers insurance) that are related to the economic meltdown, it is essential that the federal government has insurance expertise to advise the Administration and Congress on pressing domestic and international insurance matters.

It simply makes no sense for the federal government to not have insurance expertise in the executive branch. Such an office should be approved, but it must not be allowed to preempt or undermine consumer protections at the state level, or given vague, open-ended authority to conclude or interpret international agreements that include such preemption. In particular, this office should play a significant role in regulating insurance systemic risk or in working with any federal body charged with regulating systemic risk. On consumer matters, it should follow the lead of the new Federal Consumer Protection Agency, which should have the authority to offer minimum standards for credit-related insurance products and to study insurance.

D) CFA is updating its study of insurance regulation to reflect the lessons of AIG and other recent regulatory failures.

As I indicated earlier, CFA is evaluating all regulatory options to see what is the most effective system or combination of systems for protecting consumers and taxpayers, while fostering a viable insurance market. Even in these exceptional economic times, we believe that the burden of proof remains on those (including us) who 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. We are assessing both the history of insurance regulation and recent developments, such as the AIG debacle. We are evaluating the quality of state regulation from the consumer perspective, including the major flaws and successes of state regulation. We are also updating the principles we use to measure the quality of insurance regulatory systems (see Attachment 1) to reflect lessons from the current economic crisis. We have attempted to provide a detailed plan for dealing with systemic risk, while maximizing regulatory efficiency and assuring that needed consumer protections are in place.

The range of proposals under consideration includes such ideas as:

- Full federal takeover of insurance regulation.
- A federal systemic risk regulator only for systemically significant insurers.
- Partial federal takeover, with federal oversight of systemic risk and state consumer protection and assistance authority. Another hybrid approach would vest authority over property/casualty insurance at the state level and life insurance at the federal level. (See explanation above.)

- Federal minimum standards to be enforced or improved upon at the state level. Federal regulation would only occur in states that do not comply or on issues that are truly national or international in scope, such as implementation of international treaty requirements.
- Federal minimum standards for the states plus a national ("national" as opposed to federal) regulator to do the regulation in states that fail to comply with the minimum standards (authorized by a federal bill to empower the NAIC to act in areas requiring more uniformity).

At this stage of our consideration of these questions, our research points toward a system that looks something like this

- A federal office of insurance to regulate systemic risk, solvency/prudential regulation and deal with international issues related to treaties, but which does not have authority to preempt any state consumer protection standards unless such authority is explicitly defined in statute.
- Continued state regulation of consumer protection. While consumer protection standards of the states must be raised, the states have a better chance of achieving excellence in consumer protection regulation than the federal government does, we believe.
- A federal Consumer Financial Protection Agency to offer minimum standards on credit-related insurance products and to be an advocate for consumers in personal lines of insurance, i.e., homeowners and auto insurance.

Because of its historical domination by the insurance industry, however, consumer organizations are extremely skeptical about NAIC's ability to establish national minimum standards in a fair and democratic way. It is essential that the NAIC take steps so that it can operate as an effective regulatory entity, including:

- 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/FOIA applicability.
- 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 NAIC should establish a system of state funding to the NAIC at a set percentage of premiums so that all states and insured entities equally fund the NAIC.

The NAIC should also support the creation of an independent, national, public insurance counsel/ombudsman's office with significant funding to deal with NAIC and state insurance offices, as part of the CFPA. Such a presence could assist the NAIC in making the case that a deeper federal role in insurance regulation is not needed, if the states improve the quality of their consumer protection regulation. Consumers must be adequately represented in the NAIC and

state regulatory processes for the process to be accountable and credible. The current consumer participation program of the NAIC, which only pays expenses of a handful of consumer representatives to attend meetings, is woefully inadequate.

Whatever proposals emerge relating to insurance regulation, Attachment 1, *Consumer Principles and Standards for Insurance Regulation* provides detailed standards that we will use to test proposals to make sure that they properly protect consumers, whether at the state, multi-state or national level. In our study, we are reviewing all of these standards to update them regarding lessons from the economic crisis, AIG and the abdication by many states of strong consumer protection standards.

CFA Opposes Legislation to Create an 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 might be for a particular line of insurance.[26] The bills submitted to Congress so far offer little or no improvement in consumer protection or information systems to address the major problems insurance consumers have today.[27] Insurers would be able to choose whether to be regulated by this weak federal regulator or by state regulators, who would almost certainly "compete" for insurance companies to regulate by weakening standards or keeping them low.

Consumer organizations strongly oppose an optional federal charter that allows the regulated company, at its sole discretion, to pick its regulator. This is a prescription for regulatory arbitrage that can only undermine needed consumer protections. Indeed the industry drafters of such proposals have openly stated that this is their goal. If elements of the insurance industry truly want to obtain uniformity of regulation, "speed to market" and other advantages through a federal regulator, let them propose a federal approach with high consumer protection standards included that does not allow insurers to run back to the states when regulation gets tougher than they want. The merits of that type of approach are obvious. CFA and the entire consumer community stand ready to fight optional charters with all the strength we can muster.

As stated above, allowing insurers to choose who regulates them is a prescription for disaster when it comes to systemic regulation. The dual charter banking system has been proven to provide banks with an easy way to run away from regulation. "At least 30 banks since 2000 have escaped federal regulatory action by walking away from their federal regulators and moving under state supervision," says a Washington Post report.[28] State chartered banks have also used the threat of switching to a national charter to convince state regulators to keep standards low.[29] Systemic risk regulation cannot be optional. No regulation, including consumer

[26] In this Congress, the bill was introduced in the House as H.R. 1880 by Representatives Bean and Royce.
[27] See Testimony of Travis Plunkett, CFA's Legislative Director, of July 29, 2008 for a full discussion of the problems, which include unfair classifications (a key part of rate regulation), improper claims practices, insurance availability issues, particularly along the coasts and in inner cities and other issues.)
[28] By Switching their Charters, Banks Skirt Supervision," Appelbaum, Washington Post, January 22, 2009.
[29] Testimony of Travis Plunkett, Consumer Federation of America, before the Senate Banking Committee on July 29, 2008 regarding the State of the Insurance Industry: Examining the Current Regulatory and Oversight Structure.

protection regulation of any sort, can be optional and have the necessary teeth to assure insurer compliance.

H.R. 1880 would be a disaster for consumers. First, the idea of the regulated choosing its regulator is a discredited idea whose time has passed. Banks have proven the ineffectiveness of this concept.

Second, the bill would not regulate prices. Good consumer protection requires that these items be regulated. Prices include not only overall rate level but also classifications of risk. There has been an explosion of questionable classes that have caused an uproar in many states, including the use of credit scores, education and occupation, prior limit purchased, homeownership and other anti-poor, anti-minority classes to price insurance. The lack of price regulation hurts poor and minority consumers as well as those living in coastal America.

The bill also is hugely biased in favor of the insurers. For example, the insurers do not have to contribute to fund the guarantee association until after an insolvency, recreating the same systemic risks the current state system poses. There can be no logical reason for this except that this is what the insurers want. The FTC Act is not imposed on insurers. While the policy forms must be filed, there is no authority for the federal regulator to disapprove a form, setting up a competition in fine print that would leave consumers exposed to lack of coverage surprises when a claim is filed. Rulings on policy form questions are not public. The insurers even get an Ombudsman with power to request a stay in a ruling on behalf of an insurer as if they need help in complaining to a regulator.

The bill includes a dangerous section on International Agreements that seems to seek a lowest common denominator approach to consumer protection in the name of "uniformity" and "competition."

Federal insurers would have to participate in residual markets such as assigned risk plans, but there is a mischievous provision, doubtless authored by an insurer lobbyist that is an exception to such participation if it "results in rates in effect for an assigned risk plan, mandatory joint underwriting association, or any other mandatory residual market mechanism that fails to cover the expected value of all future costs associated with insurance policies written by such residual market mechanism." In other words, if a state has the audacity to reject the often bloated requests of insurers for prices, requests far above reasonable levels, the insurers can walk away from the people of the state, leaving them scrambling for insurance or requiring the state chartered insurers to pick up all of the high risks. If anyone thinks that insurers would not walk away from those they insure, I call your attention to State Farm and Allstate's odious behavior in Florida home insurance.

CFA, and all of the consumer community, vigorously opposes H.R. 1880.

CFA Favors Repeal of McCarran-Ferguson's Antitrust Exemption[30]

The history of the McCarran-Ferguson Act is replete with drama, from an industry flip-flopping on who should regulate it to skillful lobbying and manipulation of Congressional processes in order to transform the bill's short antitrust moratorium into a permanent antitrust exemption in the confines of a conference committee.

In fact, the insurance industry has long-standing anti-competitive roots. In 1819, local associations were formed to control price competition. In 1866, the National Board of Fire Underwriters was created to control price at the national level, but states enacted anti-compact legislation to control price fixing.

This increased state regulatory activity led insurers to seek a federal approach to preempt the state system. In 1866 and 1868, bills were introduced in Congress to create a national bureau of insurance, but the insurer effort was unsuccessful. Failing in Congress, the industry shifted to a judicial approach.

The case on which rode the industry's hope for court-initiated reform was *Paul v. Virginia*, 75 U.S. (8 Wall) 168 (1868). But the insurance industry's hopes were dashed when the Supreme Court ruled that states were not prohibited by the Commerce Clause from regulating insurance, reasoning that insurance contracts were not articles of commerce in any proper meaning of the word. Such contracts, they ruled, were not interstate transactions (though the parties may be domiciled in different states the policies did not take effect until delivered by the agent in a state, in this case Virginia). They were deemed, then, local transactions, to be governed by local law.

For the next 75 years, insurance regulation remained in the states, despite repeated insurance industry litigation seeking federal preemption. (Ironically, the industry would later adopt the Paul rationale to fend off enhanced federal scrutiny of its activities under the Sherman and Clayton Antitrust Acts.)

Until 1944, state regulation of insurance was secure, based on the rationale that insurance was not interstate commerce. But that assumption was repudiated in the 1944 Supreme Court decision *United States v. South-Eastern Underwriters Association*. That case brought the insurance industry's swift return to Capitol Hill to seek exactly the opposite type of relief from what it had previously advocated.

Three months after the Supreme Court denied a motion for rehearing in South-Eastern Underwriters, Senators McCarran and Ferguson introduced a bill that would become the Act bearing their names. The bill was structured to favor continued state regulation of insurance, but also, ultimately, to apply the Sherman and Clayton Antitrust Acts when state regulation was inadequate.

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[30] For a complete discussion of the reasons we favor repeal of the antitrust exemption of McCarran, see my March 7, 2007 testimony, "The McCarran-Ferguson Act: Implications of Repealing the Insurers' Antitrust Exemption," before the Committee on the Judiciary of the United States Senate.

Within two weeks of the bill's introduction, and without holding any hearings on the new measure, the Senate had passed it and sent it to the House of Representatives. As it was sent over, the McCarran-Ferguson Act provided only a very limited moratorium during which the business of insurance would be exempt from the antitrust laws.

The House Judiciary Committee also approved the bill without holding a hearing. The House floor debate indicates that House Members believed the language of the original bill already comported perfectly with the Senate amendment's stated goal of creating a limited moratorium during which the Sherman and Clayton Acts would not apply to the business of insurance.

However, despite the clear intent of both houses not to grant a permanent antitrust exemption, the conference committee proceeded to drastically transform the limited moratorium into a permanent antitrust exemption for the insurance industry. The new language provided that after January 1, 1948, the Sherman, Clayton, and Federal Trade Commission Acts "shall be applicable to the business of insurance to the extent that such business is not regulated by State law."

The House approved the conference report without debate. The sole expression of the House's intent regarding the conference report containing the new section 2(b) proviso is the statement of House managers of the conference, which indicates they intended only to provide for a moratorium, after which the antitrust laws would apply. The Senate, in contrast, debated the conference report for two days. After repeated assurances that the proviso was not intended to preclude application of the antitrust laws, the Senate passed the bill, and President Roosevelt signed it into law on March 9, 1945.

The legislative history shows that the Senate had a serious debate on the antitrust exemption, unlike the House. Senator Claude Pepper contended that the new conference language enabled the states to evade the federal antitrust laws by mere authorizing legislation. Senator O'Mahoney stated that section 2(b) of the conference report simply provided for a moratorium, after which the antitrust laws would "come to life again in the field of interstate commerce." The "state action" doctrine of *Parker v. Brown* would apply fully, he said, so that "no State, under the terms of the conference report, could give authority to violate the antitrust laws." Therefore, he concluded, "the apprehensions which [Senator Pepper] states with respect to the conference report are not well founded." Senator McCarran likewise reassured Senator Pepper that "he is in error in his whole premise in this matter."

Unfortunately, the courts construing the Act did not make these inferences. When presented with the question of what Congress meant by "regulated," the courts found no standard in the text of the statute and, declining to search for one in the legislative history, reached the very conclusion that Senator Pepper had anticipated and vainly struggled to forestall.

The antitrust exemption has been studied on several occasions by federal authorities; each time with the determination that continued exemption was not warranted. For example:

- In 1977, when I was Federal Insurance Administrator under President Ford, the Justice

Department concluded, "an alternative scheme of regulation, without McCarran Act antitrust protection, would be in the public interest."[31]

- In 1979, President Carter's National Commission for the Reform of Antitrust Laws and Procedures concluded, almost unanimously, that the McCarran broad antitrust immunity should be repealed.
- In 1983, then FTC Chairman James C. Miller III told the House Subcommittee on Commerce, Transportation and Tourism that he saw no legitimate reason to exempt the insurance industry from FTC jurisdiction.
- In 1994, the House Judiciary Committee issued its report calling for a sharp cutting back of the antitrust exemption.

For over 100 years, property/casualty insurers have used so-called "rating bureaus" to make rates for several insurance companies to use. Not many years ago, these bureaus required that insurers charge rates developed by the bureaus (the last vestiges of this practice persisted into the 1990s).

In recent years, the rate bureaus have stopped requiring the use of their rates or even preparing full rates because of lawsuits by state attorneys general after the liability crisis of the mid-1980s was caused, in great part, by insurers sharply raising their prices to return to ISO rate levels. ISO is an insurance rate bureau or advisory organization. Historically, ISO was a means of controlling competition. It still serves to restrain competition since it makes "loss costs" (the part of the rate that covers expected claims and the costs of adjusting claims) which represent about 60-70 percent of the rate. ISO also makes available expense data to which insurers can compare their costs in setting their final rates. ISO sets classes of risk that are adopted by many insurers. ISO diminishes competition significantly through all of these activities. There are other such organizations that also set pure premiums or do other activities that result in joint insurance company decisions. These include the National Council on Compensation Insurance (NCCI) and National Insurance Services Organization (NISS).

Today the rate bureaus still produce joint price guidance for the large preponderance of the rate. The rating bureaus start with historic data for these costs and then actuarially manipulate the data (through processes such as "trending" and "loss development") to determine an estimate of the projected cost of claims and adjustment expenses in the future period when the costs they are calculating will be used in setting the rates for many insurers. Rate bureaus, of course, must bias their projections to the high side to be sure that the resulting rates or loss costs are high enough to cover the needs of the least efficient, worst underwriting insurer member or subscriber to the service.

Legal experts testifying before the House Judiciary Committee in 1993 concluded that, absent McCarran-Ferguson's antitrust exemption, manipulation of historic loss data to project losses into the future would be illegal (whereas the simple collection and distribution of historic

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[31] Report of the U.S. Department of Justice to the Task Group on Antitrust Immunities, 1977.

data itself would be legal – which is why there is no need for safe harbors to protect pro-competitive joint activity). This is why there are no similar rate bureaus in other industries. For instance, there is no CSO (Contractor Services Office) predicting the cost of labor and materials for construction of buildings in the construction trades for the next year (to which contractors could add a factor to cover their overhead and profit). The CSO participants would go to jail for such audacity.

Further, rate organizations like ISO file "multipliers" for insurers to convert the loss costs into final rates. The insurer merely has to tell ISO what overhead expense load and profit load they want and a multiplier will be filed. The loss cost times the multiplier is the rate the insurer will use. An insurer can, as ISO once did, use an average expense of higher cost insurers for the expense load if it so chooses plus the traditional ISO profit factor of five percent and replicate the old "bureau" rate quite readily.

It is clear that the rate bureaus[32] still have a significant anti-competitive influence on insurance prices in America.

- The rate bureaus guide pricing with their loss cost/multiplier methods.

- The rate bureaus manipulate historic data in ways that would not be legal absent the McCarran-Ferguson antitrust law exemption.

- The rate bureaus also signal to the market that it is OK to raise rates. The periodic "hard" markets are a return to rate bureau pricing levels after falling below such pricing during the "soft" market phase.

- The rate bureaus signal other market activities, such as when it is time for a market to be abandoned and consumers left, possibly, with no insurance.

CFA endorses H.R. 1583, the "Insurance Industry Competition Act of 2009," introduced by Rep. Peter DeFazio, which would repeal the antitrust exemption that insurers enjoy today.

CFA Favors Allowing a New Financial Consumer Agency or the FTC to Study Insurance

Our insurance director, Bob Hunter, once attended a hearing here in a Senate committee where the Chairman asked the FTC Chairman to comment on a current insurance issue. The FTC Chairman said that if he had the knowledge to answer, he would be breaking the law and was excused. The insurance industry had successfully lobbied Congress to take away the FTC's authority to study insurance. The triggers for this lobbying were twofold, a study of life insurance that warned consumers about whole life insurance interest rates paid to customers on the cash value of their policies that were grossly inadequate (which the life insurers hated) and a

[32] By "rate bureaus" here I include the traditional bureaus (such as ISO) but also the new bureaus that have a significant impact on insurance pricing such as the catastrophe modelers (including RMS), other non-regulated organizations that impact insurance pricing and other decisions across many insurers (credit scoring organizations like FAIR Isaac is one example) and organizations that "assist" insurers in settling claims, like Computer Sciences Corporation (using products like Colossus).

not yet completed study of redlining by property/casualty insurers (that the property-casualty industry wanted stopped).

It makes absolutely no sense for Congress to continue to handcuff federal agencies that have the expertise to examine the effect of certain insurance practices on consumers. The new Consumer Financial Protection Agency or the FTC should be authorized to study insurance and draw conclusions as it sees fit. Consumers will be protected and the industry made stronger when it leads to a reduction in improper industry practices.

Comments on Other Federal Legislation Related to Insurance Regulation

State Modernization and Regulatory Transformation (SMART) Act

The State Modernization and Regulatory Transformation (SMART) Act was proposed by former House Financial Services Chairman Michael Oxley and Representative Richard Baker as a discussion draft in 2005. 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 have overridden important state consumer protection laws, sanctioned anticompetitive practices by insurance companies and incited state regulators into a competition to further weaken insurance oversight. It was quite simply one of the most grievously flawed and one-sided pieces of legislation that we have ever seen, with absolutely no protections for consumers. The consumers who would be harmed by it are our nation's most vulnerable: the oldest, the poorest, and the sickest.

For example, the discussion draft would have preempted state regulation of insurance rates. Imagine the impact on homeowners on the Gulf Coast of that proposal, or on companies trying to purchase D&O or bond insurance today. This would leave millions of individual and business 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 the modest state controls on territorial line drawing. States would be helpless to stop the misuse of risk classification information, such as credit scores, territorial data, education, occupation and the details of consumers' prior insurance history, for pricing purposes. The draft approach 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, thus allowing deregulated cartel behavior!

Non-admitted Insurance/Reinsurance Regulation

H.R. 2571 (D. Moore) and S. 1363 (Martinez) would preempt states only in the regulation of surplus lines of insurance and reinsurance. It provides for a method of collecting state premium taxes for surplus lines and allocating this income to the states. CFA has several concerns with this legislation:

1. Contrary to the stated intent of the authors of this legislation, this bill appears to open the door to the increased sale of poorly regulated, non-admitted personal lines of insurance to individual consumers, not just commercial insurance sold to sophisticated corporations. The bill

does not exclude non-admitted personal lines of insurance from its provisions. If the bill fosters a sharp growth in under-regulated, non-admitted insurance – as it is intended to do – it could seriously harm consumers who buy non-admitted insurance, since purchasers of such coverage have no guaranty fund protection, a real danger in the present economic circumstances.

2. Great regulatory confusion and ineptitude would likely result when the state of domicile for an insured party regulates all parts of that entity's insurance transaction. (The approach prohibits any state from overseeing surplus lines of transactions other than the home state of an insured party.) Consider how Michigan might regulate a transaction in which General Motors, or another large company based in the state, has purchased a commercial automobile policy for its cars on the West and Gulf Coasts from non-admitted insurers. In all likelihood, Michigan regulators know very little about dealing with earthquake risk in California or hurricane risk in Florida in pricing insurance policies, or in handling claims resulting from such weather events if GM's cars are damaged. Moreover, since Michigan is a no-fault state for auto insurance, regulators there would likely know very little about tort laws in other states and how pricing and claims should be handled. How can 50 regulators each become experts in the laws of all 50 states? This is regulatory super-complexity, not regulatory simplification.

3. The bill was based on the incorrect assumption that the domiciled state of an insured party or reinsurance company will provide adequate oversight. The bill handcuffs states that would have a legitimate interest in acting to protect residents harmed by clearly abusive insurance practices. For example, suppose a non-admitted insurer for a company like GM acts in bad faith and refuses to pay legitimate claims regarding unsafe automobiles that harmed drivers in other states? These states would have no ability to investigate or sanction that insurance company while the state of Michigan, with limited resources and very little in-state impact, would have much less of an incentive to get to the bottom of the problem.

Moreover, a "home state" regulator has the greatest interest in pleasing a large insured party – and employer – based in that state. This could lead the regulator to lower insurance standards that protect residents and consumers who use that company's products and services across the country.

The bill would also allow large commercial insured parties to seek coverage from non-admitted insurers without determining whether the same coverage is available from an admitted carrier, which most states now require. It is not in the public interest to foster the growth of a segment of the market that does not have to meet state standards – unless admitted insurance is truly not available. For example, guaranty associations in all states do not cover claims for surplus lines insurers from other states when an insured entity and its insurer become insolvent. This may be a minor problem for the defunct policyholder and the defunct insurer, but it certainly is not minor for the people that the policyholder may have injured who are left without guaranty association protection.

Similarly, the bill only allows the domiciled state of a reinsurance company to regulate that company's solvency. What if insured entities in the state of domicile are covered by only one percent of the reinsurance written by a particular company but entities in another state are covered by seventy-five percent of the reinsurance? Moreover, allowing a domiciliary state to essentially act as a national regulator promotes forum shopping by insurers to secure the most

favorable regulatory environment. 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 insurer. When I was Insurance Commissioner of Texas, I had to investigate and take down an insolvent insurer in another state because the commissioner of that state refused to do so, as several ex-governors were on the Board of the insurer.

4. Several deregulatory provisions of the bill are based on the faulty assumption that large buyers of insurance do not need protections that would normally be provided in an insurance transaction, such as prohibitions on deceptive practices and mandated verification of the legality of policy forms. (For example, the bill prohibits any state from overseeing surplus lines transactions other than the home state of an insured party.) The investigations and settlements pursued by New York Attorney General Eliot Spitzer refute this assumption. Large, sophisticated corporations were victimized by insurers and brokers through bid-rigging, kickbacks, hidden commissions, and blatant conflicts of interest.

A Pro-Consumer Approach to National Insurance Regulation: The Insurance Consumer Protection Act of 2003

The drafters of this legislation--introduced by Senator Hollings before he retired, considered the consumer perspective in its design. S. 1373 of 2003 would have adopted 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.

Conclusion

Congress should consider expanding the federal role in insurance regulation regarding solvency/prudential/systemic risk, minimum standards for credit-related insurance products and in studying insurance issues that affect consumer. Congress should not weaken state consumer protection regulation and should strengthen consumer protection by requiring the CFPA to adopt minimum standards on credit-related insurance lines and to advocate for insurance consumers.

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 guaranty availability.
    - Market reforms in the area of health insurance should include guaranty issue and community rating and, where needed, subsidies to assure that health care is affordable for all.
    - Information sufficient to allow public determination of unfair discrimination must be available. Geo-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

Comments of J. Robert Hunter before the Public Hearing Of the NAIC Capital and Surplus Working Group January 27, 2009

Good morning Mr. Chairman and members of the Working Group, my name is Bob Hunter. I am Director of Insurance for the Consumer Federation of America. I have served as Commissioner of Insurance in Texas and as Federal Insurance Administrator under Presidents Ford and Carter. I am delivering these remarks on behalf of CFA and also on behalf of the Center for Economic Justice.

The Economic Situation and Life Insurance Risk

Here is Page 1 of Saturday's (1/24/09) Washington Post:
"DOWNTURN ACCELERATES AS IT CIRCLES THE GLOBE",
"OBAMA TO DECIDE SOON WHETHER TO ADD TO BAILOUT,"
And on Page 1 of the BUSINESS Section "LIFE INSURERS TAKE A HIT"

As the economy of the world melts around us, consumers require more protection from all of its financial service regulators. Even Alan Greenspan understands that now is the time to toughen up consumer protections.

In the entire world, the only people involved in regulation apparently unable to understand that consumers need more protection, not less, is the NAIC. Just last week, an NAIC Working Group voted to recommend that states deregulate auto and home insurance. Today you are posed to recommend that NAIC remove dollars of protection that consumers have in their life insurance products. It is a shocking thing for you to even be considering lowering the dollars that consumers have today as protection as the balance sheets of their insurers are in crisis.

The Post life insurance article is very instructive about some of the risks facing the life insurers, whose stock index has fallen by one-third in this month on top of a similar drop late last year. The risks include a sharp drop in the values of bonds they hold, the likelihood that the ratings of some of these bonds will be cut and further declines ensue, the probability that some bonds will default, the fact that some life insurance products (such as annuities) of some insurers include guaranty returns no longer supported by the assets underlying those annuities, and the fact that analysis's are alarmed that current financial reports may reflect capital levels that are not truly reflective of the lowered values of the assets they hold. Further, captive reinsurance might artificially increase capital and appear to lower risk, while in fact the economics of such transactions do not improve the enterprise risk.

The article also points out that regulators have been trying to stop dubious accounting transactions such as deferred premium assets that already make capital look artificially high. The article says that the ACLI has opposed any retroactive action to correct this because, as the article quotes ACLI, that "would be like deconstructing an already baked cake."

Apparently, ACLI believes cakes that might protect life insurers by keeping capital artificially high cannot be sliced but the cake of consumer protection can be crumbled retrospectively to year-end 2008 and earlier.

NAIC Process Biased

This bias in the process is but one of several major problems with the deeply flawed process NAIC has followed. ACLI has a vested interest in helping its member companies lower consumer protections to pump up capital. When they propose reserve and other changes, the proposals uniformly work to lower dollars and RBC ratios currently protecting consumers. It is ACLI's job not to balance consumer interest with that of their members.

NAIC claims that its job is to protect consumers but you have not done so. Had you been doing so, the first step in a fair review is not to just look at ACLI's list of one-sided suggestions but to determine if the overall consumer protections are truly excessive before considering action to lower protection. For instance, NAIC should have studied aggregate reserves to determine if they are redundant before considering specific items suggested by a biased source. If you were sure aggregate reserves are excessive, surely you would have advised the public how excessive and why by revealing the calculations, before looking at individual items for change. Even then change should be both ways. You should not limit changes to one direction, against the consumer.

NAIC Process Rushed

The second flaw in the process is the big rush to do everything in 2 months. You should not attempt to make changes that would apply to the Annual Statements for 2008. The rush endangers the foundation of statutory accounting of valuing assets and liabilities conservatively to ensure insurers have cash to meet their claims. The explosion in affiliate investments and captive reinsurance agreements already undermines this conservatism. The current economic upheaval does too, in completely unknown ways.

Throughout the subprime and financial crises, state regulators have claimed that insurance companies are strong and that state-based regulation has protected insurance consumers as federal regulators have failed to do.

Given these claims, why has the industry sought and regulators conceded emergency and rushed treatment of these proposals? Absent a compelling reason for emergency action, these proposals should not be adopted in an emergency fashion, but should be treated according to normal procedures.

NAIC Process Closed and Secret

The NAIC Process has been unnecessarily closed and secret. When we asked why, the NAIC responded as follows:

> "The NAIC Executive Committee established the Capital and Surplus Working Group to perform its charges in an expedited manner. Given the ACLI proposals are asking about changes to reserves and other accounting requirements, many of the regulatory discussions were likely to involve company specific questions and comments. Per the NAIC open meetings policy, the discussion of company specific information is a key reason for holding regulator-to-regulator meetings."

This response is inappropriate and unacceptable. Not only has there been no company-by-company analysis, and therefore, no need to close meetings to the public, but the proposals all deal with industry-wide actions – changes in manuals and procedures affecting the entire industry. The argument that, because an individual company might be discussed, the meeting should be non-public is absurd. Using this logic, there would never be an open meeting of any sort. All meetings should be open and executive session used after the open meeting concludes if company info needs to be discussed

And how does the possibility of a specific insurer being discussed justify NAIC's secret, ex-parte meetings with ACLI? The fact that NAIC has already met secretly with ACLI undermines the argument that open meetings cannot be held because it is possible that an individual insurer's situation might come up, because that logic would preclude meetings with ACLI too.

The NAIC has refused to hold itself publicly accountable to the same type of open government standards with which state agencies must comply, even though the NAIC is taking actions that have the force of law. This is why we have challenged the actions of the NAIC as violations of state public meeting, public records and administrative procedures acts. As long as the NAIC continues to respond in this way we will continue to pursue these challenges.

Consumer Questions Remain Unanswered

NAIC's responses to our questions were incomplete or simply non-responsive in several instances.

QUESTION 1: We asked for the evidence to show that changes in reserves were needed. In response, we were told that life and annuity reserves are too conservative and that movement towards principles based reserving – relying on actuaries to certify reserve adequacy instead of relying on rules – is necessary to give industry greater flexibility and set reasonable reserve requirements.

We reject these arguments. First, where is the evidence we sought that reserves are excessive? Industry has cited "studies" by Milliman – studies done on behalf of and paid for by industry. Had Milliman determined current reserves requirements were inadequate, would we have seen that study?

Second, the concept of principles-based reserving is the same type of self-regulation by parties with conflicts of interest that led to the subprime meltdown and financial crisis worldwide. Reliance on actuaries who depend upon industry for their livelihood suffers from the same conflict found with rating agencies in the credit crisis.

QUESTION 2: We asked the NAIC to tell us the results of regulator analyses of the impact of these proposed changes on capital, surplus, reserves and RBC ratios for the industry and for individual companies most impacted by the changes.

We were astonished by your response that reads, "the impact of these proposed changes on stated versus meaningful capital and reserves *for the industry* or a particular company was not used as an analysis criteria."

This response, of course, immediately raises not only the question of why meetings were not open to the public but also questions like:

- Upon what basis is the NAIC determining that these changes will accomplish anything?
- What is the impact on the safety and soundness of insurers and will these changes leave policyholders vulnerable?

A sign of undue haste by the regulators is the complete lack of understanding of the impacts of the actions on America's policyholders.

To act without this knowledge would be irresponsible.

QUESTION 3: We asked how policyholders would be affected by the proposals, if adopted by NAIC. We were told, "Final adoption of these ACLI proposed items will not have an adverse effect on the insurance company's ability to pay its policyholder obligations." Yet no support or analysis is provided to justify this statement. Of course, this answer is, at best, misleading. It is impossible for these actions not to have an adverse effect on an insurer's ability to pay; the question is whether that adverse effect is material and necessary for insurers to remain solvent. The NAIC has refused to answer this question and instead has provided a misleading statement.

QUESTION 4: We asked if the regulators believed that the rating agencies would see these changes as an actual strengthening of capital and reserve requirements and not just cosmetic.

The NAIC did not answer this question. The reason it should be answered is that, at least at ACLI, the reason for the proposals (and for the great haste) is largely to reduce the possibility that rating agencies will lower the ratings of insurers when 2008 Statements are released.

Professor Joseph Belth's research on this question implies that the rating agencies will not be influenced by these changes, at least not in any significant way. If the reason to rush to judgment is to mollify rating agencies, then there is no need to rush if Professor Belth's research is correct. If it is not the reason why NAIC is rushing this proposal through, what is?

QUESTION 5: We asked how the various proposals would be implemented. The NAIC did not respond.

We are concerned with implementation because, in some cases, NAIC action, such as a change to certain NAIC manuals, will automatically make the adopted change effective in most states.

Therefore, the NAIC's failure to use an open public process, including the use of secret meetings and closed meetings, may violate the laws of states that require notice and open meetings, if and when they vote for such a change that becomes effective in their state.

QUESTION 6: We asked if the NAIC would help America's life insurance and annuity policyholders understand what their actions mean by demonstrating the "before and after" effect of the proposed changes on individual insurer's capital and reserve requirements.

The response was "the NAIC would simply recommend the adoption of the proposed item and the domestic regulators will have the ability to require before and after documentation."

This will pull the wool over the eyes of millions of Americans holding life and annuity contracts today. The NAIC indifference to the policyholders is troubling. Just why can the NAIC not adopt national proposals to help consumers at the very time the NAIC is adopting national proposals in undue haste to help insurers? Transparency should not be left to individual states to consider adopting if they think of it, especially since there would be insufficient time for action by the states before the 2008 Annual Statements are due on March 1, 2009, one month from now.

We propose the following language for adoption by the NAIC as part of any approval of the ACLI proposals:

> _Transparency_
>
> *In order to assist policyholders, there shall be full transparency for policyholders of what the financial impacts are from these changes adopted by the NAIC. During a transition period of the first 2 years starting with the first time these changes are applied, key capital, surplus and reserve amounts in the Statutory Annual Statement and Quarterly Statements and risk-based capital ratios shall be calculated showing amounts based on current and revised accounting and reserving rules and procedures.*

Conclusion

In conclusion, we oppose adoption of any of these changes unless the necessary research is undertaken by NAIC to justify the changes, and the important questions we have raised are answered fully and factually. We oppose allowing any of these items to be rushed into use in the 2008 Annual Statement.

If you do go forward, we request that any votes of the Executive Committee and Plenary on any recommendations from the Capital and Surplus Relief Working Group be recorded roll-call votes, so that the public can identify which regulators voted for or against the proposals.

If you move forward, we strongly urge adoption of the Transparency language we proposed earlier. We also suggest that states voting no to these proposals act to keep these proposals from becoming automatically effective in their states by asking for state exceptions to items that would automatically become effective, such as actuarial guidelines and the Accounting Practices and Procedures Manual. Finally, if you move ahead now, we offer comments on the individual

Working Group proposals as contained in my written statement. We object most strenuously to the Working Group's recommendation regarding the Deferred Tax Asset as I explain in my statement.

Answer to NAIC's Question

I would like to take one minute to respond to NAIC's written question to opponents of these proposals.

You asked: Why should NAIC not act on the request(s)? What specifically will happen if the requests are granted (how will consumer protection be decreased)?

First, NAIC should not act because there has been no analysis of the need for these capital and reserve relief proposals, no articulation of what the goals of these proposals are, no explanation of how these proposals will accomplish those goals, no analysis of the expected impact on capital and reserve levels for the industry as a whole or for individual insurance companies, and no analysis proving that consumers would not be harmed by adoption of the proposals. We ask how could any regulator responsibly vote on these proposals without these questions answered? The answer, of course, is that they cannot.

There are several specific things that will happen if you act on these proposals, including these four important ones:

1. The proposals are lessening the capital and surplus required to protect consumers. This is not my opinion -- it is the factual intent of the proposals. In some cases, the requirements for reserves will be lessened, in other cases, the amount of liquid assets representing surplus will be reduced. So the question, how will consumers be harmed is the wrong question -- the proposals by definition are harming consumers. The question really is -- will the reduction in reserves and capital requirements put consumers at a materially greater risk. The problem with the proposals -- and with the entire decision-making process -- is that regulators have not answered this primary question. There are general statements about redundant reserves, but no independent analysis. By what measure have regulators determined reserves are redundant? A study by Milliman paid for by insurers? Please. By what measure have regulator determined that a reduction in liquid assets supporting capital -- the effect of the DTA plan -- will not put some insurers at solvency risk? The fact that regulators have not analyzed - or provided the analysis to the public -- of what the impact on capital and risk based capital ratios will be is incomprehensible for us. What will the impact of these changes be -- on average and in the extreme cases? How can you vote for these proposals if you don't know whether you are increasing the reported capital by 1%, 10% or 20%? Or what the impact on reserves is for specific products? The absence of this type of analysis means that regulators cannot answer your own initial question -- how do you know the impact on consumers will not be material?

2. Consumer faith in life insurance products will be reduced.

3. If there is no transparency as part of the action, consumer groups will have to warn all

persons calling that we are unable to know the impact of these changes on their specific company and that they should be more cautious than ever before about purchase or maintenance of life insurance products.

4. The consumer faith in state regulation, already falling faster than the Dow, will be dealt another blow. To give you one key indicator, for the first time CFA is actively rethinking our long support of state regulation and may be soon proposing a very significant federal role.

Description of Types of Consumer Credit Insurance Coverage

Credit insurance refers to a group of insurance products sold in conjunction with a loan or credit agreement. Credit insurance makes payments for the consumer to the lender for a specific loan or credit agreement in particular circumstances. The common types of credit insurance sold include:

- *Credit Life* pays off the consumer's remaining debt on a specific loan or credit card account if the borrower dies during the term of the coverage.
- *Credit Accident and Health,* also known as *Credit Disability,* pays a limited number of monthly payments on a specific loan or credit card account if the borrower becomes disabled during the term of coverage.
- *Credit Involuntary Unemployment* pays a limited number of monthly payments on a specific loan or credit card account if the borrower becomes involuntarily unemployed during the term of coverage.
- *Credit Personal Property* typically pays to repair or replace property that is serving as collateral for a loan.
- *Creditor-Placed Insurance* is auto or property insurance placed by a lender if the consumer fails to maintain the insurance required by the terms of the auto or home loan.
- *Credit Family Leave* makes monthly payments if the borrower goes on an approved family leave.
- *Credit GAP* pays the difference – or gap – between the amount owed on the auto loan and the amount paid by the insurance company on the auto insurance policy in the event there is an accident resulting in a total loss to the vehicle and the amount of insurance payoff is less than the amount owed on the loan. GAP is sometimes used as acronym for Guaranteed Auto Protection.
- *Non-Filing* pays the lender in the event loan documents have not been correctly filed.
- *Mortgage Guaranty* pays the lender in the event the borrower defaults on the mortgage loan.

Attachment 4

Properly Regulating Credit Insurance "Look Alike" Products

Many insurance products are perfect or near-perfect substitutes for financial products; it is logical for the CFPA to represent consumers on all substantively similar products.

Consumer credit insurance products are – from the consumer's perspective – equivalent to debt cancellation contracts and debt suspension agreements – products which federal banking regulators have declared to be banking products.

Debt Cancellation Contracts (DCCs) and related products like Debt Suspension Agreements (DSAs) are products sold in connection with a consumer loan and which promise to provide some debt relief to the consumer if certain events occur. The events triggering the benefit under the DCCs/DSAs are typically events that impair the borrower's income or place a financial burden on the borrower. DCCs/DSAs are part of the group of payment protection products that include credit insurance and which promise, among other things, to preserve the borrower's credit rating in adverse circumstances.

Since 2000, lenders have shifted their payment protection product offerings from credit insurance to DCCs/DSAs, initially in connection with credit cards and more recently in connection with closed-end loans. One of the earliest forms of DCC sold in connection with a closed-end loan was GAP Waiver sold in connection with auto loans.

To a consumer, DCCs and credit insurance are very similar – or even identical – products. For a one-time or monthly fee, DCC will cancel the debt or make monthly payments if certain events occur – just as credit insurance performs. For example, a credit card credit insurance program containing credit life, credit disability and credit involuntary unemployment coverages provides the identical benefits for a consumer as a DCC program for death, disability and involuntary unemployment.

The major difference between credit insurance and DCC is in regulatory oversight. Federal banking regulators have declared DCC to be a banking product and, consequently, not subject to state insurance regulation if sold by banks or credit unions with federal charters. Although state insurance regulators challenged these decisions, claiming that DCC was an insurance product, banks who sought the federal oversight of DCC and the federal agencies have prevailed in legal challenges. State regulation of DCCs offered by state-chartered financial institutions has generally followed the federal rules.

The rationale for not regulating DCC as an insurance product is that, unlike credit insurance, where a borrower, a lender and an insurance company are involved, there are only two parties involved with DCC – the borrower and the lender. The DCC is an addendum to the loan contract that states that, under certain circumstances, the lender will cancel the debt or the monthly payment. So, in theory, no insurance company need be involved.

In practice, DCC programs are administered in almost the same manner as credit insurance programs. Credit insurance companies provide the same administrative and sales services as with credit insurance. The lender purchases a contractual liability policy from the credit insurance company, and this policy pays any claims made under the DCC program offered by the lender. Credit insurance companies, including CUNA Mutual, now sell and administer DCC programs as well as credit insurance programs.

The difference in regulatory oversight of DCC versus credit insurance is dramatic. With credit insurance, the products (policy forms) must be approved by state insurance regulators prior to use and the rates subject to prima facie maximum rate regulation. A credit insurer wishing to offer a national program must obtain approvals in all states and comply with different rates in all states as well as variations in product requirements among the states. Under rules promulgated by the Office of the Comptroller of the Currency (OCC) and other federal financial regulators, lenders can offer a single DCC product nationally. Lenders have moved from credit insurance to DCC for several reasons:

- No oversight or limitations on fees charged
- Few limitations on product design and benefit provisions – no restrictions on bundling, flexibility in product design
- Ability to use one product nationally
- No agent licensing requirements
- No form or rate filing requirements
- No premium taxes

DCCs and DSAs generally provide much worse value to consumers than credit insurance – higher prices, fewer benefits and fewer consumer protections. In prior reports and testimony, CFA has estimated the loss ratio for DCCs and DSAs to be less than 5%. In addition to lower benefit payouts, the administrative costs for DCCs are lower than for credit insurance because of the ability to utilize a single program across the states, the absence of product filings and approvals, and the absence of a premium tax.

Failure to allow the CFPA to represent insurance consumers will lead to regulatory arbitrage – the shifting of banking products to insurance products.

When the federal banking regulators declared debt cancellation contracts to be banking products – and not subject to state insurance regulation – lenders started changing their products from credit insurance to debt cancellation or debt suspension to take advantage of the more favorable (to lenders) regulatory structure for the debt cancellation and debt suspension products. This is one example of regulatory arbitrage – regulated entities playing off competing regulators for the most advantageous – to the regulated entities – regulatory regime. Failure to include credit-related insurance products under the jurisdiction of the CFPA would reverse that trend, encouraging financial institutions to shift from use of regulated bank products to less regulated insurance products. Consumers would be the losers.