ACORN
AFL-CIO
ALABAMA WATCH
ALASKA PIRG
AMERICAN COUNCIL ON CONSUMER AWARENESS, INC.
ARIZONA CONSUMERS COUNCIL
ARIZONA PIRG
CALIFORNIA HEALTH ADVOCATES
CALIFORNIA PIRG
CALIFORNIA REINVESTMENT COALITION
CENTER FOR JUSTICE & DEMOCRACY
CHICAGO CONSUMER COALITION
CITIZEN ACTION OF NEW YORK
COLORADO PIRG
CONCERNED CLERGY COALITION OF KANSAS CITY (MO)
CONSUMER ACTION
CONSUMER FEDERATION OF AMERICA
CONSUMERS FOR AUTO RELIABILITY AND SAFETY
CONSUMERS UNION
CONSUMERS UNITED (MN)
DRUM MAJOR INSTITUTE (NY)
FLORIDA CONSUMER ACTION NETWORK
FOUNDATION FOR TAXPAYER AND CONSUMER RIGHTS
MASSACHUSETTS AFFORDABLE HOUSING ALLIANCE
MASSACHUSETTS CONSUMERS' COALITION
MASSACHUSETTS PIRG
NAACP
NATIONAL CONSUMER LAW CENTER
NEIGHBORHOOD ECONOMIC DEVELOPMENT ADVOCACY PROJECT
NEW JERSEY CITIZEN ACTION
OREGON CONSUMER LEAGUE
PEOPLE'S MEDICAL SOCIETY
PUBLIC INTEREST LAW OFFICE OF ROCHESTER
PULSE-COLORADO
TEXANS FOR PUBLIC JUSTICE
US ACTION
USPIRG
VIRGINIA CITIZENS CONSUMER COUNCIL
WEST VIRGINIA CITIZEN ACTION

April 18, 2005

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

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

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

Dear Representatives Oxley and Baker:

We understand that you have scheduled an eight-week process to review and prepare for mark-up the "State Modernization and Regulatory Transparency Act" (SMART). **The undersigned consumer, civil rights, labor and community organizations strongly oppose this deregulatory legislation, especially at a time when investigations by the Attorney General of New York and the Securities**

and Exchange Commission have exposed massive failures in the existing regulatory structure for insurance. As part of your review process, we submit the attached comments that detail our significant concerns with the SMART discussion draft.

Attorney General Spitzer's investigation has demonstrated that even the most sophisticated buyers of insurance, those with risk managers and other insurance experts employed to help in their purchase decisions, have been duped by the sharp practices of insurance companies and producers. **Rather than increase insurance consumer protections for individuals and small businesses while spurring states to increase the uniformity of insurance regulation, this sweeping proposal would override important state consumer protection laws, sanction anticompetitive practices by insurance companies and incite state regulators into a "race to the bottom" to further weaken insurance oversight.** It is quite simply one of the most grievously flawed and one-sided pieces of legislation that we have ever seen: a veritable "wish list" of items requested by insurers with absolutely no protections offered for consumers. The consumers who will be harmed by it are our nation's most vulnerable: the oldest, the poorest and the sickest.

For example, the discussion draft would preempt state regulation of insurance rates. This would leave millions of consumers vulnerable to price gouging, as well as abusive and discriminatory insurance classification practices. In two recent studies, the Consumer Federation of America found the same potential for conflicts-of-interest in payments made by insurers to the sellers of personal lines of insurance that New York Attorney General Elliot Spitzer has uncovered in commercial insurance.[1] These payments can provide agents and brokers with an incentive to overcharge consumers or inappropriately delay the filing of a claim. The draft would also encourage a return to insurance redlining, as deregulation of prices would include the lifting of state controls on territorial line drawing. States would also be helpless to stop the misuse of risk classification information, such as credit scores, territorial data and the details of consumers' prior insurance history, for pricing purposes.

What the draft does not do is as revealing as what is does require. It does not create a federal office to represent consumer interests, although the draft creates two positions to represent insurer interests in Title XV. It takes no steps to spur increased competition in the insurance industry, such as providing assistance to the millions of consumers who find it extremely difficult to comparison shop for this complex and expensive product, or eliminating the antitrust exemption that insurers currently enjoy under the McCarren-Ferguson Act. It does not lift Congressional restrictions that prevent the Federal Trade Commission from investigating deceptive or fraudulent acts in the insurance industry. Insurers are not required to disclose by geography where they write their policies to deter redlining or meet community reinvestment requirements, as are banks. Nothing is done to prevent insurers from using inappropriate information, such as credit scores or a person's income, to develop insurance rates.

Since consumers foot the bill when regulatory inefficiencies exist, we are certainly not opposed to increasing uniformity in state insurance regulation -- as long as high consumer protection standards are applied. Unfortunately, however, in almost every circumstance in which the draft attempts to ensure uniformity, it overrides strong state laws and chooses the weakest consumer protection approach possible.

[1] "Contingent Insurance Commissions: Implications for Consumers," Consumer Federation of America, January 26, 2005, http://www.consumerfed.org/contingent_commissions_study.PDF; "The Impact of Commissions on Prices and Service Quality for Home and Automobile Insurance," Consumer Federation of America, February 24, 2005, http://www.consumerfed.org/commissions_home_auto_study.PDF.

Overall, this draft is an extraordinary step back for insurance consumers. Rather than "modernize" insurance regulation and deal with the regulatory failures highlighted in the New York and SEC investigations, this draft would re-open the door to some of the worst insurance abuses of the past, such as cartel pricing and redlining, and tie the hands of states that attempt to stop abusive insurance practices and unfair and disparate pricing. We join both the National Conference of Insurance Legislators (NCOIL) and National Association of Insurance Commissioners in rejecting the SMART proposal in no uncertain terms.

We strongly urge the drafters of this proposal to return to the drawing board, this time with the needs of consumers and small business owners in mind. If you have questions about our concerns, please contact Travis Plunkett at the Consumer Federation of America at (202) 387-6121.

Sincerely,

ACORN
AFL-CIO
Alabama Watch
Alaska PIRG
American Council on Consumer Awareness, Inc.
Arizona Consumers Council
Arizona PIRG
California Health Advocates
California PIRG
California Reinvestment Coalition
Center for Justice & Democracy
Chicago Consumer Coalition
Citizen Action of New York
Colorado PIRG
Concerned Clergy Coalition of Kansas City (MO)
Consumer Action
Consumer Federation of America
Consumers for Auto Reliability and Safety
Consumers Union
Consumers United (MN)
Drum Major Institute (NY)
Florida Consumer Action Network
Foundation for Taxpayer and Consumer Rights
Massachusetts Affordable Housing Alliance
Massachusetts Consumers' Coalition
Massachusetts PIRG
NAACP
National Consumer Law Center, on behalf of its low-income clients
Neighborhood Economic Development Advocacy Project
New Jersey Citizen Action
Oregon Consumer League
People's Medical Society
Public Interest Law Office of Rochester
Pulse-Colorado

Texans for Public Justice
US Action
USPIRG
Virginia Citizens Consumer Council
West Virginia Citizen Action

CC: The Honorable Barney Frank
The Honorable Paul E. Kanjorski
Members of the House Financial Services Committee
Members of the Senate Banking Committee

HOW THE "SMART" ACT WOULD HARM CONSUMERS

1. **State rate regulation would be preempted**. Most states review rate increases prior to their implementation today. Title XVI of the discussion draft would eliminate this protection. For most lines of insurance, the draft would eliminate rate regulation after two years. During the two-year phase-in period, rates would be allowed to rise by 7 percent and 12 percent overall without state oversight, although rates for individual consumers would be able to rise by any amount. Elimination of rate regulation is harmful and undemocratic. It overrides decades of support for rate regulation by state legislators, and in some cases, a vote by the general public. Moreover, insurance is not a typical "product" and is not subject to normal competitive forces. Free market competition alone will not result in rates that are fair and affordable. Insurance policies are exceedingly complex legal documents. Most consumers can't look at an insurance policy and tell for sure whether it offers adequate coverage at a fair price. Comparison shopping is very difficult because the amount, type and pricing of coverage can vary greatly. Moreover, once a policy is purchased, the real test of its effectiveness may not come for decades -- until a claim arises. Two examples of the failure of rate deregulation are the recent chaos in California's workers' compensation insurance market and in the Texas homeowners' insurance market. In contrast, under the strong consumer protection rules of California's Proposition 103, which regulates property and casualty insurance in that state (except for workers' comp), consumer challenges to proposed rate hikes have saved insurance policyholders more than $300 million in the past two years alone. (For many reasons why insurance is not a normal product for the purposes of regulation, see the attached fact sheet.)

2. **States would also be blocked from preventing insurance abuses triggered by the misuse of classification information**. The deregulation of rates in the draft also deregulates the classification systems insurers use to price customers and policies. Classification systems are regulated by most states because insurers can maximize profits by denying older and sicker people health insurance or by denying inner city residents home and auto insurance. For example, most insurers use credit scoring for insurance rating, which segregates out poorer people for denial or for higher prices. Moreover, significant concerns have been raised about the accuracy of credit reports and credit scores,[2] raising the real possibility that millions of Americans might be overcharged by insurers that use consumers' credit scores to place them in one of up to 50 rate "tiers." Some insurers now want to use human genome data to price life insurance and Global Positioning Satellites to track consumers in order to price auto insurance. Regulation is required to control classification abuses – the number of potentially "innovative" class systems that violate consumer rights and privacy is quite large. Information is also needed to police these abuses, such as zip code data to determine where insurers are issuing policies and how much consumers in those areas are being charged. Although states currently review these class systems to ensure fairness and protection of privacy, this draft would prohibit them from doing so in the future. Discrimination against people because of their income is not prohibited under the draft, so redlining and other unfair practices would likely result.

3. **New anti-competitive practices would be sanctioned and encouraged.** Title XVI, Section 1601(c) of the draft deregulates insurance rating and advisory organizations, such as the Insurance Services Office and the National Council on Compensation Insurance. It applies the deregulation of rates and classifications to these organizations, including the two-year flex rating transition

[2] "Credit Score Accuracy and Implications for Consumers," Consumer Federation of America and National Credit Reporting Association, December 17, 2002.

period. These organizations function as industry-wide cartels, colluding in the setting of rates or parts of rates, which they file on behalf of many insurance companies. The draft also keeps in place the anti-trust exemption that the insurance industry enjoys under the McCarran-Ferguson Act, one of the few industry-wide antitrust exemptions allowed anywhere in federal law. In other words, this draft not only strengthens the ability of insurance executives and these cartel-like organizations to act in an anti-competitive manner, it ties the hands both of states that wish to examine these activities and of persons who are adversely impacted by what would be antitrust violations if it were not for the antitrust exemption. There can be no economic theory that justifies this total deregulation of insurance cartel behavior.

4. **The draft would prohibit any state from moving to hold rates in check because of a natural disaster or other unusual market conditions.** In the wake of Hurricane Andrew and again after the four hurricanes that hit Florida last year, the State of Florida had to act to control price gouging. The draft would prohibit Florida or any state from taking the same steps in response to future natural disasters. Interestingly, Title XVI, section 1601 (g) of the draft does not deregulate medical malpractice insurance, presumably because the market is somewhat non-competitive today. Thus, the drafters are "a little bit pregnant" on the issue of what to do in a non-competitive line of insurance. Doctors are protected from unjust rate increases in today's somewhat non-competitive market, but homeowners, auto owners and small business owners, who experience non-competitive markets every decade or so (due to the boom and bust insurance cycle) are not protected.

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

6. **The draft would require no representation of consumer interests.** Title XV, Section 1501 (i) of the draft designates two federal officials to act as advocates for the insurance companies, one before international bodies and another before federal agencies. No similar representation is required for insurance consumers. The bill does not create an insurance consumer advocate's office to advocate on behalf of consumers before the states, the "Partnership," international bodies or federal agencies. It helps those who need no help -- insurers who can fund such activities and pass the costs on to their policyholders -- and ignores consumers who have very little representation and few resources. To add insult to injury, the only federal agency with extensive consumer protection expertise – the Federal Trade Commission -- is currently forbidden under

federal law from even studying insurance issues without a Congressional request. The FTC should be empowered to review consumer issues related to insurance and a consumer advocate should be established to represent consumer interests before the Partnership and the states.

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

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

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

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

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