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COMMENTS OF THE CONSUMER FEDERATION OF AMERICA

REGARDING
REVIEW BY THE TREASURY DEPARTMENT
OF THE REGULATORY STRUCTURE ASSOCIATED
WITH FINANCIAL INSTITUTIONS
(TREASURY-DO-2007-0018)

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I. GENERAL ISSUES

The Consumer Federation of America (CFA)[1] appreciates this opportunity to comment as part of the Treasury Department's evaluation of the regulatory structure associated with financial institutions. CFA does not have a position on the question of regulatory structure addressed in this request for comments. What is critical to us is not the locus of regulation, but the quality of the standards and the effectiveness of enforcement of those standards. In other words, we are concerned less with regulatory form than with regulatory effectiveness. As a result, our comments address the urgent need for regulatory reform that is focused on strengthening consumer and investor protections, the key underlying causes of ineffective financial regulation that must be addressed if financial regulation is to be improved, and the principles that should guide any such pro-consumer/pro-investor regulatory reform.

Assessment Should Focus on Improving Regulatory Effectiveness

The Treasury Department indicates in its request for comments that this effort is being undertaken as one of several initiatives focused on "maintaining the competitiveness of the United States capital markets." CFA would like to preface our comments by noting our view that concerns about the competitiveness of U.S. capital markets have been grossly exaggerated, and furthermore that those concerns understate the preeminent role strong regulation and effective consumer and investor protection play in assuring our markets' ability to attract capital, by far the most important measure of market competitiveness. Even those who do not share these views, however, must acknowledge that much has changed since the Treasury Department first announced its efforts to promote U.S. markets' competitiveness. Specifically, our country and indeed the world are now mired in a mortgage crisis, and a broader credit crisis, that was brought about as the direct result of a regulatory failure of monumental proportions.

As in the accounting scandals that recently brought down Enron, WorldCom, and a host of other public companies, regulatory failures occurred at all levels of the regulatory structure and, in this case, across a host of financial industry sectors. For example:

- State and federal regulators responsible for overseeing the mortgage industry failed to prevent lending practices that were, in some cases, predatory, in others, imprudent and unsound.

- Moreover, because they apparently failed to recognize the degree to which securitization's ability to spread risk had removed the incentive for lenders to control risk, these regulators also failed to take appropriate steps to rein in risky lending practices with an eye toward protecting the safety and soundness of the system.

[1] CFA is a nonprofit association of some 300 national, state, and local pro-consumer organizations created in 1968 to represent the consumer interest through research, advocacy, and education.

- Despite the growing importance of credit rating agencies to the overall economy and their repeated failures to accurately identify and measure looming risks, neither Congress nor the Securities and Exchange Commission (SEC) has come up with an effective system for improving credit rating quality or ensuring that credit rating agency conflicts-of-interest do not undermine that quality.

- The SEC has also so far failed to hold investment bankers accountable for failing to adopt appropriate due diligence standards when underwriting mortgage-based securities or to hold brokers and investment advisers accountable for failing to ensure their suitability for the investors who bought them.

- Neither the Financial Accounting Standards Board (FASB) nor the International Accounting Standards Board (IASB) developed accounting standards that appropriately reflected the complexity of structured investment vehicles (SIVs). Moreover, fair value accounting standards allowed companies to use mark-to-model methods for valuing mortgage-backed securities that failed to accurately reflect the drop in value that resulted when the credit markets dried up.

- Nor did accounting standards, or the auditors responsible for assuring that those standards are followed, prevent investment banks from inappropriately removing risks associated with SIVs from their financial statements. It is as yet unclear whether the SEC will use its principles-based authority to assure that financial statements fairly present the financial condition of the company to hold investment banks accountable for issuing misleading disclosures.

While the present mortgage foreclosure crisis is the most dramatic regulatory failure since the collapse of Enron, it is far from alone. In the wake of hurricanes Katrina and Rita, for example, state insurance regulators have, for the most part, shown themselves unable or unwilling to protect consumers from unreasonable rate hikes or from abusive claims payment practices. Decades of bid rigging and kickbacks in the insurance industry went unchecked until uncovered by an investigation of the New York Attorney General. In the 1990s, insurance regulators failed to uncover evidence that some of the nation's largest life insurers engaged in market conduct abuses related to disappearing premiums and other anti-consumer sales practices. The securities industry has also reeled from scandal to scandal since the beginning of this decade, with widespread abuses uncovered in areas as diverse as mutual fund trading practices, backdating of stock options, and IPO allocation practices, in addition to the highly publicized accounting and analyst scandals. Finally, federal banking regulators have failed to act against a number of predatory credit practices, in some cases because of a lack of authority but in others because of an apparent lack of will. (Examples of a number of regulatory failures by banking agencies can be found in the attached testimony delivered by CFA Legislative Director Travis B. Plunkett to the House Financial Services Committee on July 25, 2007.)

In light of this compelling evidence of a massive regulatory failure, any analysis of our system of financial regulation undertaken in the current environment should be focused primarily on determining what went wrong, why regulation failed to prevent problems or contain the damage, and what can be done to make our regulatory system more effective. Any proposal to reform our financial regulatory system should be judged primarily by how it would have prevented these and other regulatory failures. In making this assessment, regulatory effectiveness should be measured by the system's ability to provide effective consumer and investor protection, as well as to prevent market crises and promote the safety and soundness of our financial system. With this in mind, as the Department conducts its assessment, we encourage you to focus more on financial regulators' ability to regulate effectively in light of "evolving market dynamics" (an ability that has been called into question by recent events) and less on the ability of financial institutions to adapt to change, an area where they have historically shown themselves to be extremely adept.

We do not mean to suggest that other issues -- such as reducing regulatory overlap or increasing regulatory efficiency -- are not also valid concerns. Our point is simply that they are secondary concerns when weighed against the recent failures of financial regulators to effectively protect the safety and soundness of the financial system and the well-being of consumers and investors. Ideally, regulation should be both effective and efficient, and we recognize that consumers pay the price for inefficient regulation. However, they also pay the price for ineffective regulation. In our view, the pressing immediate need is to make financial regulation more effective. Focusing primarily on efficiency, as the initiatives to promote market competitiveness have seemed to do, is a luxury we do not have in the current crisis.

"Principles-Based" Regulation Is Not a Solution

Some have suggested that the United States should adopt a more "principles-based" approach to financial services regulation in order to improve regulatory efficiency and promote U.S. competitiveness. Some have even suggested that such an approach would strengthen consumer and investor protection, by allowing regulators to nimbly apply broad-based regulatory principles on a case-by-case basis based on broad legal principles. This, they say, would make it more difficult for financial institutions to maintain technical compliance with the letter of the law while violating its spirit. Such arguments are naïve in our view, ignoring a number of inherent weaknesses to the principles-based approach that raise serious questions about its likely effectiveness.

First, and perhaps foremost, those who advance this view seem to overstate the ease with which regulators would be able to apply those broad regulatory principles. Determining whether specific conduct violates a regulatory principle is of necessity a subjective process. In instances where regulators and the entities they regulate have differing views over whether particular conduct complies with the regulatory principle, those differences are likely to be resolved in one of two ways: either they will be worked out in negotiations between the company and the regulator, or if that fails, the regulator may have to defend its interpretation in court.

In most cases, differences are likely to be worked out in closed negotiations between the regulator and the regulated company. In marked contrast to the public rulemaking process, such an approach will tend to shield the decision-making process from public scrutiny and deny the public any opportunity for input. This is particularly problematic in light of the close relationship that often exists between regulators and the industries they regulate. As a result, it is likely to seriously undermine public confidence in the fairness and integrity of the system. Such a case-by-case approach also creates the very real threat that principles will be applied inconsistently from firm to firm or from year to year, and that changes will be adopted without the transparency and accountability of the public rulemaking process.

When negotiations break down, companies that disagree with a regulator's application of regulatory principles are likely to challenge those regulatory actions in court. As we noted above, deciding whether a principle has been applied appropriately is far more subjective than deciding whether a specific rule has been broken. Courts are likely to decide such cases differently, creating confusion and resulting in inconsistent application of the law. Once again, members of the public will be denied the input that the rulemaking process provides. There is the added disadvantage that regulatory decisions will be removed from the purview of the regulators with expertise and handed over instead to the court system. This is at best a costly, inefficient, and ineffective way to set regulatory policy. In reality, it is likely to make regulators all too willing to apply regulatory principles in ways that do not trigger court challenge. That in turn could lead to the kind of lax enforcement that has characterized the United Kingdom's Financial Services Authority.

Another problem with the principles-based approach to regulation is that even those who advocate it most strongly usually don't support it in practice. Both the Chamber of Commerce and the Committee on Capital Market Regulation, for example, have advocated a more principles-based approach to financial services regulation while simultaneously calling for bright line regulations and "safe harbors" to govern in the areas of materiality and scienter. Just recently, the White House criticized as "subjective" a provision in the House mortgage reform bill that would require lenders to make only suitable loans that borrowers have a reasonable expectation of repaying. The concept of suitability has a lengthy precedent in the securities industry, and it is a perfect example of the many principles-based regulations already embedded in our current regulatory system. Nonetheless, the mortgage industry has voiced similar complaints, arguing that what is needed is a clear, quantifiable standard that can be applied to every borrower. Insurers have also consistently fought suitability requirements on similar grounds. In short, even those who typically advocate a principles-based approach to regulation object to its lack of clarity and certainty when they see it in practice.

Finally, as the above example makes clear, our current regulatory system is replete with examples of principles-based rules. Among them: the prohibition against "unfair and deceptive acts and practices" in the Federal Trade Commission Act, which bank regulators have the authority to enforce against the institutions they regulate; the requirement that financial statements be prepared in a way that fairly represents the financial condition of the company; and the requirement that securities firms refrain from engaging in any practices that might deceive their customers, to name just a few. In reality, most of the detailed rules that have been adopted have been added for one of two reasons: either they were needed to address widespread abusive practices that occurred despite the fact that they clearly violated regulatory principles, or they were sought by industry to provide greater clarity on how to comply with principles they viewed as overly vague.

In short, the case can be made for providing a clearer statement of the many principles that under-gird our regulations, and for seeking to promote greater uniformity of principles across the various financial services industries. However, this will only benefit consumers and investors if it is provided as a supplement to add clarity and consistency to our rules-based system, not as a replacement, or even a partial replacement, for that system. Replacing our current system with a more principles-based approach would diminish transparency and clarity, would rob the public of an important opportunity to participate in the regulatory process, and would in all likelihood lead to weaker enforcement.

<u>Underlying Causes of Regulatory Failures Must Be Addressed</u>

Consolidating regulation of financial services industries within a single federal agency has been suggested primarily as a way to streamline regulation, but it has also been suggested that this approach could improve the quality of regulation. As we have noted above, CFA has not taken a position for or against such regulatory consolidation. We can see both potential benefits and dangers in such an approach.

On the plus side, a consolidated regulator might be more likely to apply uniform principles to comparable products and services offered by different industries. Major changes in the financial system, particularly in the ways in which financial services are provided to the public, have worked to blur distinctions between deposit taking banks and thrifts and non-depository financial institutions. In today's marketplace, both banks and non-banks provide transaction services, offer savings and investment opportunities, and make loans and offer other credit products to consumers. Consumers frequently do not fully appreciate these distinctions, sometimes to their detriment. Nor are many consumers aware of significant distinctions in the level and quality of consumer protections deriving from different federal and state regulatory regimes. Thus, from a consumer perspective, there is a critical need for principles, such as fairness and transparency, to apply broadly and comprehensively to all financial products and services regardless of their source.

If a consolidated financial services regulator were to apply more uniform standards, and if it applied uniformly high standards, the end result could be greater clarity and consistency in financial services regulation. Consumers and investors might also find such a structure easier to navigate, when they have complaints to report, for example, or are seeking information. Such an approach would also minimize, if not eliminate, the opportunity for financial services firms to engage in regulatory arbitrage -- using the competition among different regulators to drive down the rigor of regulations.

On the other hand, the effectiveness of a consolidated federal financial services regulator might be seriously undermined by the complex and sometimes conflicting roles that regulator would be asked to play. Also, competition among regulators has occasionally benefited consumer and investor protection, when one or more regulators "got out ahead of the crowd" in adopting effective regulations or taking strong enforcement actions and was able to encourage less willing regulators to follow suit. Furthermore, the likelihood that a consolidated regulator would act to strengthen consumer and investor protections is called into question by the fact that this proposal is being put forward as a way to streamline regulation and promote competitiveness, not improve regulatory effectiveness. In fact, one could argue that a consolidated regulator that does not have to take into consideration the views of other regulatory agencies could be more subject to regulatory capture.

Ultimately, a consolidated approach to financial services regulation would only benefit consumers and investors if the newly consolidated regulator were to adopt high standards of conduct and enforce them effectively. Unless and until the underlying causes of ineffective regulation are identified and addressed, simply creating a consolidated regulator, or adopting a more principles-based approach to regulation, is highly unlikely to change the culture that has caused the various financial services regulatory agencies to ignore festering problems and to reject adequate consumer protection measures.

The nature of these underlying causes varies somewhat from agency to agency, and similar problems may manifest themselves differently at different agencies. That said, there is a great deal of overlap in the factors that undermine regulatory effectiveness. These problems include:

- **Regulators who are too close to the industries they regulate.**

At all of the financial services regulators, a "revolving door" exists between the regulator and the regulated industry. This revolving door has been particularly evident among insurance commissioners. For example, four of the last seven presidents of the National Association of Insurance Commissioners (NAIC) have since gone on to lobby for the insurance industry, while one has gone to work for and another has been elected to serve on the board of a major insurance company. This is particularly troubling given the important role of the NAIC in state insurance regulation and its lack of public accountability. While the example of the NAIC is extreme, it is no different in kind from what occurs at the securities and banking agencies.

This revolving door can and often does result in regulatory agencies that are infused with the attitudes and biases of the regulated industry. It also raises questions about the willingness of regulators to impose tough pro-consumer, pro-investor rules or principles that they may later have to live with once they leave the regulator and work for the industry. When members of the regulatory staff are hoping to move into more lucrative industry jobs, it may make them unwilling to offend members of the industry they will later be looking to for employment. Moreover, because of the relationships they build up while working at the regulatory agency, members of the industry who are former regulators find it easier to gain access to and to influence members of the regulatory staff. This access gives them far more influence than affected consumers and investors have in shaping regulatory proposals, from the earliest stages of development to the final fine-tuning.

At the banking agencies, this conflict is exacerbated by the fact that these agencies receive significant funding from industry sources. None of the banking agencies receive appropriated funds from Congress.[2] Given that it supervises the largest financial institutions in

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[2] The OCC and Office of Thrift Supervision (OTS) receive virtually all of their income from direct assessments on the institutions they supervise. The FDIC is funded by premiums that banks and thrift institutions pay for deposit insurance coverage and from earnings on investments in Treasury securities. The Federal Reserve System receives the greatest portion of its income from interest earned on government securities, but it does receive substantial

the country, the Office of the Comptroller of the Currency's (OCC) funding situation is the most troublesome and offers perhaps the best example of how such conflicts can undermine effective regulation. As Professor Arthur Wilmarth recently pointed out in testimony before the House Financial Institutions and Consumer Credit Subcommittee, more than 95 percent of the OCC's budget is financed by assessments paid by national banks, and the twenty biggest national banks account for nearly three-fifths of those assessments.[3] This may help to explain why the OCC has not initiated a single public enforcement order against any of the eight largest national banks for violating consumer credit laws since early 1995 and why it has so assiduously advanced these large banks' agenda of preempting state regulation.

- **Regulatory balkanization that leads to downward pressure on consumer protections or results in cooperative action to raise standards that is extremely slow.**

The present regulatory system tends to be institution-centered, rather than consumer-centered. It is structured according to increasingly irrelevant distinctions between the type of institution offering a particular product or service, rather than by the type of product or service being offered to consumers. As we have noted above, the most obvious possible benefit of a consolidated federal financial services regulator is that it would reduce the regulatory balkanization that can lead to a race to the bottom among regulators or, when agencies work together to raise standards, results in interminable delays.

Where regulated entities have the ability to choose their regulator, they may do so based on which offers the least rigorous regulation. This is certainly true in the credit arena, where differing standards between the agencies has led in some cases to agency "charter shopping."[4] As a result, regulators often appear to be overly concerned that the requirements they place on the institutions they regulate might be viewed by these institutions as a "regulatory burden," even if highly justified for consumer protection purposes. In fact, "reducing regulatory burden" has become something of a mantra for financial services regulators, who are all too willing to reduce these regulatory burdens, even when it means that important protections are reduced.

The same force is at work behind some members of the insurance industry's support for an optional federal charter. Insurers have a long history of seeking regulation at the level they perceive will be weakest. It is not surprising that, today, the industry would again seek a federal role at a time they perceive little regulatory interest at the federal level. But, rather than going for full federal control, they have learned that there are ebbs and flows in regulatory oversight at the federal and state levels, so they seek the ability to switch back and forth at will. Further, the insurance industry has used the possibility of an increased federal role to pressure NAIC and the states into gutting consumer protections over the last seven years. Unfortunately for consumers, the strategy has already paid off. Believing that reducing state consumer protections is the way to "save" state regulation, by placating insurance companies and encouraging them to stay in the

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income from what it calls "priced services to depository institutions," bank examinations, inspections, and risk assessments of bank holding companies.

[3] Testimony of Arthur E. Wilmarth, Jr., Professor of Law, George Washington University Law Schoo, House Financial Services Subcommittee on Financial Institutions and Consumer Credit, April 26, 2007.

[4] Agency "charter shopping" is not a viable option in most cases for national banks, but it can be for thrifts and for state chartered banks, which can and do choose between supervision by the Federal Reserve system and the FDIC and between a state and national charter.

fold, the NAIC has moved suddenly in the last few years to cut consumer protections adopted over a period of decades.

On the other hand, we have seen a contrary example of the securities industry, where the existence of multiple regulators has sometimes led to more rigorous regulation. The most dramatic recent example came with the New York Attorney General's investigations into conflicts of interest among securities analysts. In this case, problems had been well documented, were known to be widespread, and fell well within the authority of federal regulators. But those regulators failed to act until spurred to do so by the New York investigation. The New York investigation into market timing at mutual funds had a similar effect. A key difference here, of course, was that state and federal regulators both had jurisdiction. As a result of this shared jurisdiction, securities firms have not had the same ability some banking institutions have -- and insurance companies seek -- to choose their regulator. This minimizes the opportunity for securities firms to engage in regulatory arbitrage. Another difference is that these investigations occurred within the Attorney General's office, which is less likely to have a cozy relationship with the firms under its jurisdiction than other regulators, such as insurance departments.

Contrast this with the significant barriers that have been placed in the way of the current New York Attorney General as he has sought to address mortgage lending abuses that occurred within his state. Because states are preempted from enforcing consumer protection laws against federally chartered depository lenders, New York was limited to taking legal action against one of the nation's largest real estate appraisal management companies and its parent corporation for colluding with the largest savings and loan in the country to inflate the appraisal values of homes. The state could not sue the federal lender itself.[5]

This is just one example of how state preemption has made it more difficult for state officials to protect their citizens from abusive practices. Some in the securities industry have sought a similar preemption of state securities regulation. Clearly, however, it is in the interest of consumers to restore state authority to enforce consumer protection laws against national banks, not preempt that authority with regard to securities firms. If state preemption were rolled back, consumers might benefit from competition among regulators that drives regulatory quality up, not down.

Even among federal banking regulators, consumers have occasionally benefited from divided regulatory authority, when one agency was quicker to acknowledge the existence of a problem and helped convince others of the need to act. When agencies do collaborate to apply consumer protections consistently to the institutions they regulate, however, the process can be staggeringly slow. The sluggish regulatory response to well-publicized problems in the sub-prime mortgage lending market has clearly contributed to the scope and seriousness of the current credit crisis. Unfortunately, that delay is all too typical. For example, as credit card debt loads began to increase for Americans in the mid and late 1990s, consumer organizations and credit experts began to issue serious warnings that the lower minimum payment amounts that all credit card issuers were offering their cardholders were contributing to the sharp increase in the

[5] American Banker, "Appraisal Suit Unlikely to Be Last One: N.Y. AG," November 2, 2007.

number of consumer bankruptcies.[6] But it was not until January 2003 that regulators issued guidance recommending that credit card lenders increase the size of the minimum payment amounts so that consumers would "amortize the current balance over a reasonable period of time," noting that prolonged negative amortization would be subject to bank examiner criticism.[7] Issuers were not required to fully phase in the changes until the end of 2006, close to a decade after initial concerns were raised.

While regulatory consolidation offers the possibility of a more timely response to emerging problems, that is far from guaranteed. Numerous examples can be cited of proposals to strengthen investor protections that have languished for years, even where a single federal agency, the SEC, has clear authority to act. For example, many of the proposals put forward in the wake of recent mutual fund scandals have never been acted on. A proposal to improve the disclosures provided to investors by investment advisors, first put forward in 1999, has yet to make it before the Commission for final adoption. Such delays could be even more common at a bulky consolidated financial services regulator with jurisdiction over a vast array of issues, particularly as it seeks to balance the sometimes competing interests of different industry players.

- **An excessive focus on "prudential" regulation and the regulatory conflict between ensuring institutional safety and soundness and protecting consumers.**

One concern we have with the proposal to create a consolidated financial services regulator -- coming as it does is part of an effort to "streamline regulation" and promote competition -- is that it will result in the same kind of weakening of consumer and investor protections that has sometimes been the result of regulatory balkanization. It is especially troubling to us that many of those advocating regulatory consolidation have suggested that the "more prudential" model of regulation adopted by banking regulators should prevail within such an agency. By "more prudential," advocates of this approach typically refer to a regulatory style that both focuses more on safety and soundness than on consumer protection and that relies more on inspection than on enforcement. But this "prudential" approach to regulation has been a notable failure in protecting consumers from abusive credit practices, including those that have led to the recent mortgage foreclosure crisis.

One reason banking regulators have been slow to act to stem abusive credit practices is their overwhelming focus on safety and soundness regulation, often to the exclusion of consumer protection. All four of the primary banking regulatory agencies examine and supervise banks, with a major focus of this supervision being the financial safety and soundness of the institutions.[8] These agencies are also charged with enforcing consumer protection laws that

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6 Day, Kathleen and Caroline E. Mayer, "Credit Card Penalties, Fees Bury Debtors," *The Washington Post*, March 6, 2005.

7 Joint Press release of Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency and Office of Thrift Supervision, "FFIEC Agencies Issue Guidance on Credit Card Account Management and Loss Allowance Practices," January 8, 2003.

8 The OCC and OTS charter supervise national banks, and thrifts, respectively. State chartered banks can choose whether to join and be examined and supervised by either the Federal Reserve System or the Federal Deposit Insurance Corporation (FDIC). The FTC is charged with regulating some financial practices in the non-bank sector, such as credit cards offered by department stores and other retailers.

affect the institutions they supervise, but in many cases do not appear to make consumer protection a significant budget or strategic priority.[9] The obvious problem with vesting both safety and soundness and consumer protection with a single agency is that the agency might well view the two goals as in conflict or place too high a priority on safety and soundness enforcement to the exclusion of consumer protection.[10] A perfect example is offered by the Federal Reserve Board's inaction on overdraft loans. As this case shows, an agency focused almost exclusively on what is financially beneficial for banks would likely view a restriction on bank loan income as a threat to the bank's financial stability, even if the practice in question is financially harmful to consumers. If anything, this problem leads to the conclusion that consumer protection regulation should be separated from safety and soundness oversight and vested with an agency free of industry conflicts-of-interest, a structural form not addressed in the Department's request for comments.

Another problem with the "prudential" approach to regulation practiced by federal banking regulators is its undue focus on bank examination instead of enforcement. Bank regulators have consistently argued that the process of supervision and examination results in a superior level of consumer protection to taking enforcement action against institutions that violate laws or rules. For example, Comptroller of the Currency John Dugan told the House Financial Services Committee in June that "…ours is not an 'enforcement-only' compliance regime – far better to describe our approach as 'supervision first, enforcement if necessary,' with supervision addressing so many early problems that enforcement is not necessary."[11] Given the widespread consumer abuses in the credit card market documented above and the OCC's ineffectual regulation of national banks like Providian that committed these abuses, this claim is simply not supported by the facts. Similar claims are made by the United Kingdom's Financial Services Authority, with little basis in fact.

There is another serious problem with relying almost exclusively on the examination process to require national banks to comply with laws and regulations: the process is highly discretionary and not open to public view. As Professor Art Wilmarth noted in April testimony before the House Financial Services Committee:

> Findings made during compliance examinations are strictly confidential and are not made available to the public except at the OCC's discretion. Similarly, the OCC is not required to publish the results of its safety-and-soundness orders….Thus, the OCC's procedures for compliance examinations and safety-

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[9] The OTS, for example, cites consumer protection as part of its "mission statement" and "strategic goals and vision." However, in identifying its eight "strategic priorities" for how it will spend its budget in Fiscal Year 2007, only part of one of these priorities appears to be directly related to consumer protection ("data breaches"). On the other hand, OTS identifies both "Regulatory Burden Reduction" and "Promotion of the Thrift Charter" as major strategic budget priorities. Office of Thrift Supervision, "OMB FY2007 Budget and Performance Plan," January 2007.

[10] Safety and soundness concerns at times can lead to consumer protection, as in the eventually successful efforts by federal banking agencies to prohibit "rent-a-charter" payday lending, in which payday loan companies partnered with national or out-of-state banks in an effort to skirt restrictive state laws. However, from a consumer protection point-of-view, this multi-year process took far too long. Moreover, the outcome could have been different if the agencies had concluded that payday lending would be profitable for banks and thus contribute to their soundness.

[11] Testimony of John C. Dugan, Comptroller of the Currency, Before the Committee on Financial Services of the U.S. House of Representatives," June 13, 2007.

and-soundness orders do not appear to provide any public notice or other recourse to consumers who have been injured by violations identified by the OCC.[12]

At best, these factors combine to create a culture of coziness with regulated institutions at many of the agencies. At worst, as in the case of the OCC, they appear to have led to regulatory capture. If combined with a more principles-based approach to regulation, there is a very real threat that any meaningful opportunity for the public and for consumer and investor advocates to participate in the process would be eliminated.

Pro-consumer Principles Should Guide Regulatory Reform

Regulatory reform efforts designed to provide much-needed improvements to the quality of financial services regulation must be based on pro-consumer, pro-investor principles. These principles could be applied within a consolidated financial services regulator, but they are needed regardless of whether any changes to regulatory structure are made. We therefore urge the Treasury Department to include these principles in its assessment of regulatory structure. But we also recognize that changes to the regulatory structure are likely to come slowly, if at all. We therefore also urge all the financial services regulators to adopt the principles below.

1. Regulators should be independent of the industries they regulate.

Consumers should enjoy a regulatory structure that is transparent and accountable to the public, promotes competition and choice, remedies market failures and abusive practices, preserves the financial soundness of the various financial services industries, protects depositors' and policyholders' funds, and is responsive to the needs of consumers. In order to help ensure that this occurs, consumers should have a meaningful opportunity to participate in the regulatory process and be adequately represented in that process. Steps should be taken to ensure that regulators are free from the conflicts of interest that undermine public confidence in the independence and fairness of the regulatory process. Efforts should be made to decrease the proportion of agency funds provided by regulated companies -- especially when a significant amount comes from a small number of very large institutions -- insulate agency decision-making procedures from industry-provided funding, and eliminate the ability of financial services companies to choose the agency that regulates them.

2. Regulators should be required to regularly assess the effectiveness of their consumer and investor protections and suggest improvements.

Federal agencies must meet statutory requirements regarding the reduction of regulatory burdens and "paperwork" on regulated industries, but no such requirement exists for consumer protection. In order to redress this imbalance, financial services regulators should be subject to a similar requirement to regularly investigate key emerging consumer issues and concerns and to make recommendations to Congress regarding changes in supervision, regulation and law that should be adopted. The agencies should be required to consult consumer representatives, state regulators, and Attorneys General as part of this review.

[12] Testimony of Arthur E. Wilmarth, Jr., Professor of Law, George Washington University Law Schoo, House Financial Services Subcommittee on Financial Institutions and Consumer Credit, April 26, 2007.

3. **The financial products and services offered to consumers should be designed to benefit those consumers.**

Too often, financial products and services seem to be designed to benefit primarily the financial institutions that market them rather than the consumers and investors who purchase them. One of the most meaningful reforms financial services regulators could adopt would be to hold the institutions they regulate accountable for providing products and services that are designed to benefit consumers and investors. Consistent with that principle, they should apply a suitability obligation to all sales of financial services and products. Advisory services should be subject to a fiduciary duty.

4. **Consumers should have access to timely and meaningful information about the costs, terms, risks, and benefits of the financial products and services marketed to them.**

The financial services industries have provided consumers with abundant choices among competing products and services. Often, however, the products are complex, and the information provided to consumers is incomplete or incomprehensible. In order for consumers to benefit from the choices available to them, and to protect themselves from inappropriate choices, they need clearer and timelier disclosure. To the extent possible, these disclosures should make it easy for consumers to compare similar products and services, even when they are offered by different types of financial institutions that are subject to different regulatory regimes.

5. **All consumers should reap the benefits of technological changes in the marketplace that decrease prices and promote efficiency, transparency, and convenience. They should be protected from technological changes that threaten their privacy and information security.**

Technological changes offer opportunities for financial services companies to provide products and services at lower costs, price those products and services more accurately, provide information in a more timely and transparent fashion, and promote consumer and investor convenience. Regulators should act to ensure that consumers do in fact reap these benefits. At the same time, however, technological changes also threaten to erode consumer privacy and information security. In order to minimize these threats, regulators should hold financial institutions they regulate accountable for adopting strong privacy and security protections. In keeping with that principle, consumers should have control over whether their personal information is shared with affiliates or third parties.

6. **Consumers should have access to a meaningful redress mechanism when they suffer losses from fraud, deceptive practices, or other violations.**

No efforts to improve regulatory effectiveness will completely eliminate fraud or abuse from the marketplace. However, consumers who are victims of wrongdoing must have effective means to recover their losses. This should include a right to take complaints to court, access to fair and efficient arbitration, and effective enforcement that holds wrongdoers directly accountable to consumers.

Conclusion

Financial services regulation is badly in need of reform, but the primary focus of that reform should be to strengthen the protections provided to consumers and investors, not reduce its burdens on industry. Consumers have been the victims of a seemingly endless stream of financial abuses in recent years: from the hyped up recommendations of securities analysts, to the failure of property-casualty insurers to make fair payment on hurricane-related claims, to a whole host of abusive lending practices, including mortgage lending practices that now threaten millions of Americans with the loss of their home. The price of these regulatory failures is enormous, and is borne by consumers in the form of depleted retirement savings, onerous debt burdens, communities that are slow to recover from disaster, and an economy that is being dragged down by credit woes. While consumers also pay the costs of inefficient regulation, those costs pale in comparison to the heavy burdens imposed on consumers by ineffective regulation. Financial services regulation can be made more effective, but only if regulators are willing to abandon old ways and adopt an approach to regulation that puts consumers and investors first. As the Department conducts its assessment of financial services regulation, we urge you to champion such an approach.

II. SPECIFIC ISSUES

2.2 Insurance

To respond to the questions on insurance regulation, we attach recent testimony by CFA Insurance Director J. Robert Hunter delivered to the House Financial Services Committee on October 30, 2007, that outlines CFA's positions and recommendations on each of the questions posed. This testimony includes an in-depth review of the successes and failures of state regulation from a consumer perspective.[13]

Although we suggest reviewing the entire document to for a thorough evaluation of the consumer strengths and weaknesses of state insurance regulation and proposals to federalize this oversight, we cite below the sections of this testimony that respond to specific questions asked by the Department:

Treasury Question	CFA Testimony Page Number	Topic
2.2.1	11	Top Six Problems Facing Insurance Consumers Today
	25	NAIC Failures to Protect Consumers
	29	California's Success in Protecting Insurance Consumers and Spurring Competition
2.2.2	10	Consumers Do Not Care Who Regulates, but About The Quality of Regulation
	24	Why Some but Not All Insurers Once Again Favor Federal Insurance Regulation
	32	Evaluation of Recent Federal Proposals to Alter Regulation
	37	Principles for Measuring the Effectiveness of Consumer Protection in Insurance Regulation
	20	Why Repeal of the McCarran-Ferguson Act's Antitrust Exemption is the Most Important Federal Action Needed
2.2.3	11	List of Whether States or the Federal Government is Better Equipped to Do Certain Regulatory Actions
	20	Why Repeal of the McCarran-Ferguson Act's Antitrust Exemption is the Most Important Federal Action Needed

[13] Testimony of J. Robert Hunter, Director of Insurance of CFA, before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services of the U.S. House of Representatives, "Additional Perspectives on the Need for Insurance Regulatory Reform," October 30, 2007.

2.2.4 10 Why Insurance Regulation is More Important than Ever[14]

[14] There are significant differences between market failures requiring residual markets from state to state. For instance, few states outside of California need an Earthquake Pool and only 18 states face severe hurricane risks.

TESTIMONY OF TRAVIS B. PLUNKETT
LEGISLATIVE DIRECTOR, CONSUMER FEDERATION OF AMERICA

BEFORE THE COMMITTEE ON FINANCIAL SERVICES OF THE U.S. HOUSE OF REPRESENTATIVES

ON BEHALF OF CONSUMER ACTION, CONSUMER FEDERATION OF AMERICA, CONSUMERS UNION, CENTER FOR RESPONSIBLE LENDING, NATIONAL CONSUMER LAW CENTER AND THE U.S. PUBLIC INTEREST RESEARCH GROUP

IMPROVING FEDERAL CONSUMER PROTECTIONS IN FINANCIAL SERVICES

JULY 25, 2007

Chairman Frank, Ranking Member Bachus and Members of the Financial Services Committee, my name is Travis Plunkett and I am the Legislative Director of the Consumer Federation of America (CFA).[15] I appreciate the invitation to testify today on behalf of a number of national consumer organizations with tens of millions of members, including CFA, Consumer Action,[16] Consumers Union,[17] the publisher of Consumer Reports, the Center for Responsible Lending,[18] National Consumer Law Center[19] and the U.S. Public Interest Research Group.[20]

I commend the Committee for its diligence in examining the extremely important question of how well federal regulators are protecting consumers in the fast changing, increasingly complex financial services marketplace. This is the second hearing that the Committee has held on this topic, while many Committee and Subcommittee hearings this year have touched on regulation of important financial services markets, including mortgage lending, credit cards and other bank loans.

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[15] **Consumer Federation of America** (CFA) is a non-profit association of 300 consumer groups, with a combined membership of more than 50 million people. CFA was founded in 1968 to advance the consumer's interest through advocacy and education.

[16] **Consumer Action** (www.consumer-action.org), founded in 1971, is a San Francisco based nonprofit education and advocacy organization with offices in Los Angeles and Washington, DC. For more than two decades, Consumer Action has conducted a survey of credit card rates and charges to track trends in the industry and assist consumers in comparing cards.

[17] **Consumers Union** is a nonprofit membership organization chartered in 1936 under the laws of the State of New York to provide consumers with information, education, and counsel about goods, services, health and personal finance; and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived form the sale of *Consumer Reports*, its other publications and services, and from noncommercial contributions, grants, and fees. In addition to reports on Consumers Union's own product testing, *Consumer Reports* with approximately 5 million paid circulation, regularly carries articles on health, product safety, marketplace economics, and legislative, judicial, and regulatory actions which affect consumer welfare. Consumers Union's publications and services carry no outside advertising and receive no commercial support.

[18] **The Center for Responsible Lending** is a nonprofit, nonpartisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, one of the nation's largest community development financial institutions.

[19] The **National Consumer Law Center** is a non-profit organization specializing in consumer issues on behalf of low-income people. NCLC works with thousands of legal services, government and private attorneys, as well as community groups and organizations, who represent low-income and elderly individuals on consumer issues.

[20] The **U.S. Public Interest Research Group** is the national lobbying office for state PIRGs, which are non-profit, non-partisan consumer advocacy groups with half a million citizen members around the country.

I. Summary of Concerns and Recommendations

Any discussion about the quality of federal financial services regulation must begin by mentioning the "elephant in the living room." The Supreme Court's recent decision in Watters vs. Wachovia Bank, N.A. represents the culmination of efforts by the Office of the Comptroller of the Currency (OCC) to cut off the long-standing ability of states to protect the consumers of national banks. OCC's preemptive efforts harm consumers because, while not perfect in many respects, states have traditionally had the experience, the regulatory infrastructure, the willingness to experiment and the desire to protect consumers. Unfortunately, the OCC has serious deficits in all of these categories. In fact, over the years, the OCC appears to have demonstrated a lot more interest and expertise in exercising preemptive authority than in protecting consumers. Our recommendation is for Congress to clarify and limit the OCC's preemptive authority, as Representative Gutierrez has proposed, restoring the ability of the states to assist in protecting consumers who purchase financial services from national banks.

We recommend a number of consumer protection standards that the Committee can use to evaluate the effectiveness of financial services regulation, whether state or federal, and to propose changes to improve federal efforts. One of the most difficult problems that the Committee will face in attempting to improve consumer protection efforts is a culture of coziness with the financial institutions they regulate at most of the agencies and an insensitivity to consumer concerns. For example, most of the regulatory failures we highlight today are in areas, like oversight of high-cost "overdraft" loans, where federal regulators <u>have</u> existing authority to act and have chosen not to do so. Simply increasing the authority of the agencies to write or enforce rules, or to offer a unified complaint hotline, will not change the culture in some agencies that has caused them to ignore festering problems in the credit arena or to reject adequate consumer protection measures.

In order to improve federal consumer protection efforts, serious underlying problems with this regulatory culture must be addressed, including a focus on safety and soundness regulation to the exclusion of consumer protection, the huge conflict-of-interest that some agencies have because they receive significant funding from industry sources, the balkanization of regulatory authority between agencies that often results in either very weak or extraordinarily sluggish regulation (or both) and a regulatory process that lacks transparency and accountability.

The key to addressing these root problems is to make the regulatory process more independent of the financial institutions that are regulated. This means allowing the Federal Trade Commission (FTC) to bring enforcement actions against national banks and thrifts for unfair and deceptive practices and to initiate regulation of these entities. It also means granting consumers the right to privately enforce federal laws. Finally, Congress should act to rein in lending abuses where agencies have shown an unwillingness to act vigorously, such as credit card lending, sub-prime mortgage lending and the use of deceptive and high-cost "overdraft" loans by national banks.

II. Achieving Strong Consumer Protection in the Credit Arena, Whether at the State or Federal Level

The Supreme Court's recent ruling in Watters vs. Wachovia Bank, N.A., upheld a regulation by the Department of Treasury's Office of the Comptroller of the Currency (OCC) that permits operating subsidiaries of national banks to violate state laws with impunity. The court ruled that the bank's operating subsidiary is subject to OCC superintendence – even if there effectively is none – and not the licensing, reporting and visitorial regimes of the states in which the subsidiary operates. This split 5-3 court decision all but guarantees ongoing controversy and will likely mean that federal banking regulators will be encouraged to apply federal preemption to new entities associated with national banks.

The practical effect of the exercise of far-reaching federal preemption authority as now permitted by the courts is that it prevents states from using their historical authority to protect consumers and communities in large parts of the financial services arena and leaves a huge consumer protection gap that federal regulators have not shown an inclination or an ability to fill. The OCC has even sought to prevent state attorneys general and regulators from enforcing state laws that it concedes are not preempted. The recent court ruling encourages national banks and their subsidiaries to ignore even the most reasonable of state consumer laws.

Worse still, it promotes further competition to lower consumer protections. States are already getting pressure to reduce protections in order to retain state-chartered banks, and federal regulators have an incentive to keep standards lax, in order to continue to attract the participation of large state-chartered institutions in the federal banking and thrift system.[21] We have already seen that the expanding scope of federal preemption has intensified efforts by state banks and other state regulated financial entities to ask both federal and state regulators to provide them with parallel exemptions.

The truth is that the states have many advantages when protecting consumers in the credit practices arena. States can experiment with different consumer protection approaches more easily. Americans throughout the country have been the beneficiary of this experimentation many times as effective state laws are modeled and adopted in other states and at the federal level.[22] States have the flexibility to respond to variations in problems with credit practices from region-to-region. Given their smaller districts, state legislators are more likely to be responsive to problems in the credit market that surface in certain areas, before they spread nationally. States have an infrastructure in place to license, bond, and otherwise regulate the wide variety lenders, agents, servicers and brokers that offer credit services. State and local enforcement officials are better known to the public than their federal counterparts and more likely to have the

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[21] Several large national banks have chosen in recent years to convert their state charter to a national charter. Charter switches by JP Morgan Chase, HSBC and Bank of Montreal (Harris Trust) alone in 2004-05 moved over $1 trillion of banking assets from the state to the national banking system, increasing the share of assets held by national banks to 67 percent from 56 percent, and decreasing the state share to 33 percent from 44 percent. Arthur E. Wilmarth, Jr., "The OCC's Preemption Rules Threaten to Undermine the Dual Banking System, Consumer Protection and the Federal Reserve Board's role in Bank Supervision," Proceedings of the 42nd Annual Conference on Bank Structure and Competition (Fed. Res. Bank of Chicago, 2006) at 102, 105-106.

[22] Among the many examples that could be provided are The Truth in Lending Law and provisions of the Fair and Accurate Credit Transactions (FACT) Act.

personnel, experience and infrastructure to properly resolve consumer complaints about lenders and their agents.

Nonetheless, we certainly do not contend that states always provide effective consumer protection. The states have also been the scene of some notable regulatory breakdowns in recent years, such as the failure of some states to properly regulate mortgage brokers and non-bank lenders operating in the sub-prime lending market, and the inability or unwillingness of many states to rein in lenders that offer extraordinarily high-cost, short term loans and trap consumers in an unsustainable cycle of debt, such as payday lenders and auto title loan companies. Conversely, federal lawmakers have had some notable successes in providing a high level of financial services consumer protections in the last decade, such as the Credit Repair Organizations Act and the recently enacted Military Lending Act.[23]

As the Committee moves forward to examine the implications of the Watters decision on consumers and the effectiveness (or lack thereof) of federal consumer protection efforts, we urge you to use the below consumer protection principles to determine where federal consumer protection laws and regulations must be upgraded, as well as where federal efforts should accede to or partner with state regulation. These are the standards that should apply in evaluating the effectiveness of any consumer protection efforts, whether at the state or federal level.

- **Protection from unfair, deceptive and abusive practices**, including those that unjustifiably increase the cost of the credit product or expose consumers to unexpected fees and costs.
- **Protection from unsustainable debt**, as measured by the borrower's ability to re-pay the loan, caused by such factors as usury, rate gouging, or high fees.
- **Effective redress**, through a private right of action, and timely investigation and resolution of complaints by regulatory bodies, and other appropriate redress mechanisms, such as performance bonds. Access to such redress should not be blocked or unnecessarily delayed through such methods as mandatory arbitration requirements, choice-of-law contract terms, required waivers of legal rights, prohibitions on class action litigation, or unjustifiable restrictions on access to bankruptcy.
- **Strong civil enforcement** by federal and state authorities, including Attorneys General and federal consumer protection authorities, e.g. the Federal Trade Commission (FTC).
- **High standards for comparable products applied to all creditors**, whether a product is offered by a bank, a bank affiliate, a third party contracting with a bank, or a non-bank entity. Conflicting standards should always be harmonized upward to protect consumers.
- **Safety and soundness protections,** such as appropriate licensing, bonding, examination, and supervision requirements.
- **Timely, clear and complete disclosure** of all costs, as well as consumer rights and obligations and contract terms.

[23] Military Lending Act, 10 U.S.C. § 987. Credit Repair Organizations Act, 15 U.S.C. § 1679h (giving state Attorneys General and FTC concurrent enforcement authority).

III. Widespread Federal Regulatory Failures beyond the Mortgage Lending Market Have Harmed Consumers

Since the beginning of the year, a major focus of Congressional oversight of the credit market has been the serious regulatory failures at the federal and state level in the sub-prime mortgage lending market. Given the fact that at least 2.2 million homeowners with sub-prime mortgages face the prospect of losing their homes over the next several years (1 in 5 sub-prime loans issued in 2005 and 2006 are projected to default), this focus is understandable.

However, the focus on sub-prime mortgage lending may have obscured the failures of federal financial services regulators to address a number of other significant lending abuses by banks in recent years. If the Committee is to consider measures to improve consumer protection enforcement by federal financial services regulators, it is necessary to be aware of how and why these abuses have been allowed to continue.

A. The Federal Reserve Board and Office of the Comptroller of the Currency Have Done Very Little Beyond Proposing New Disclosures to Address Abusive Practices and Reckless Lending in the Credit Card Market

The Subcommittee on Financial Institutions and Consumer Credit has conducted two very comprehensive hearings on the impact of current credit card issuer practices on consumers. The Committee heard testimony from academics and consumer representatives regarding abusive lending practices that are widespread in the credit card industry, including:

- The unfair application of penalty and "default" interest rates that can rise above 30 percent;
- Applying these interest rate hikes retroactively on existing credit card debt, which can lead to sharp increases in monthly payments and force consumers on tight budgets into credit counseling and bankruptcy;
- High and increasing "penalty" fees for paying late or exceeding the credit limit. Sometimes issuers use tricks or traps to illegitimately bring in fee income, such as requiring that payments be received in the late morning of the due date or approving purchases above the credit limit;
- Aggressive credit card marketing directed at college students and other young people;
- Requiring consumers to waive their right to pursue legal violations in the court system and forcing them to participate in arbitration proceedings if there is a dispute, often before an arbitrator with a conflict of interest; and
- Sharply raising consumers' interest rates because of a supposed problem a consumer is having paying another creditor. Even though few credit card issuers now admit to the discredited practice of "universal default," eight of the ten largest credit card

issuers continue to permit this practice under sections in cardholder agreements that allow issuers to change contract terms at "any time for any reason."[24]

The Subcommittee also heard about the inaction of banking regulators in responding to these problems in the credit card marketplace:

- The Federal Reserve Board (FRB) has proposed new disclosure regulations under Regulation Z of the Truth in Lending Act (TILA). Although these proposed disclosures are positive and many respects and will make it easier to understand credit card terms and conditions, they will not include all of the information necessary to help consumers make informed choices. Most importantly, the disclosures won't stem the most abusive practices in the market.[25]
- The OCC has taken public enforcement action against a major credit card issuer only twice in recent years. The best-known case involved deceptive marketing practices by Providian. However, this occurred only after the San Francisco District Attorney and California Attorney General initiated action against Providian.[26]
- "In contrast to this absence of public enforcement action by the OCC against major national banks, state officials and other federal agencies have issued numerous enforcement orders against leading national banks or their affiliates, including Bank of America, Bank One, Citigroup, Fleet, JP Morgan Chase, and US Bancorp – for a wide variety of abusive practices over the past decade…"[27]

The OCC and FRB have also been largely silent while credit card issuers expanded efforts to market and extend credit at a much faster speed than the rate at which Americans have taken on credit card debt. This credit expansion has had a disproportionately negative effect on the least sophisticated, highest risk and lowest income households. It has also resulted in both relatively high losses for the industry and record profits. That is because, as mentioned above, the industry has been very aggressive in implementing a number of new – and extremely costly – fees and interest rates.[28] Although the agencies did issue significant guidance in 2003 to require issuers to increase the size of minimum monthly payments that issuers require consumers to pay,[29] neither agency has proposed any actions (or asked for the legal authority to do so) to rein in aggressive lending or unjustifiable fees and interest rates.

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[24] Testimony of Linda Sherry of Consumer Action, House Subcommittee on Financial Institutions and Consumer Credit, April 26, 2007.
[25] Testimony of Kathleen E. Keest, Center for Responsible Lending, U.S. House Committee on Financial Services Subcommittee on Financial Institutions and Consumer Credit, June 7, 2007.
[26] Testimony of Edmund Mierzwinski, U.S. Public Interest Research Group, Subcommittee on Financial Institutions and Consumer Credit of the Financial Services Committee, June 2, 2007.
[27] Testimony of Arthur E. Wilmarth, Jr., Professor of Law, George Washington University Law School, House Financial Services Subcommittee on Financial Institutions and Consumer Credit, April 26, 2007.
[28] Testimony of Travis B. Plunkett of the Consumer Federation of America, Senate Banking Committee, January 25, 2007.
[29] Joint Press release of Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency and Office of Thrift Supervision, "FFIEC Agencies Issue Guidance on Credit Card Account Management and Loss Allowance Practices," January 8, 2003, see attached "account Management and Loss Allowance Guidance" at 3.

B. The Federal Reserve has Allowed Debit Card Cash Advances ("Overdraft Loans") without Consent, Contract, Cost Disclosure or Fair Repayment Terms

The FRB has refused to require banks to comply with the Truth in Lending Act (TILA) when they loan money to customers who are permitted to overdraw their accounts. While the FRB issued a staff commentary clarifying that TILA applied to payday loans, the Board refused to apply the same rules to banks that make nearly identical loans. As a result, American consumers spent $17.5 billion last year on cash advances from their banks without signing up for the credit, getting cost-of-credit disclosures, or a contract that the bank would in fact pay overdrafts. Consumers are induced to withdraw more cash than they have in their account at ATMs and spend more than they have with debit card purchases at point of sale. In both cases, the bank could simply deny the transaction, saving consumers average fees of $34 each time.

The FRB has permitted banks to avoid TILA requirements because bankers claim that systematically charging unsuspecting consumers very high fees for overdraft loans they did not request is the equivalent to occasionally covering the cost of a paper check that would otherwise bounce. Instead of treating short term bank loans in the same manner as all other loans covered under TILA, as consumer organizations recommended, the FRB issued regulations under the Truth in Savings Act, pretending that finance charges for these loans were bank "service fees." Once again, national consumer organizations provided well-researched comments, urging the Federal Reserve to place consumer protection ahead of bank profits, to no avail.

As a result, consumers unknowingly borrow billions of dollars at astronomical interest rates. A $100 overdraft loan with a $34 fee that is repaid in two weeks costs 910 percent APR. The use of debit cards for small purchases often results in consumers paying more in overdraft fees than the amount of credit extended.

Cash advances on debit cards are not protected by the Truth in Lending Act prohibition on banks using set off rights to pay themselves out of deposits into their customers' accounts. If the purchase involved a credit card, on the other hand, it would violate federal law for a bank to pay the balance owed from a checking account at the same bank. Banks routinely pay back debit card cash advances to themselves by taking payment directly out of consumers' checking accounts, even if those accounts contain entirely exempt funds such as Social Security.

C. Despite Advances in Technology, the Federal Reserve has Refused to Speed up Availability of Deposits to Consumers

Despite rapid technological changes in the movement of money electronically, the adoption of Check 21 to speed check processing, and electronic check conversion at the cash register, the Federal Reserve has failed to shorten the amount of time that banks are allowed to hold deposits before they are cleared. Money flies out of bank accounts at warp speed. Deposits crawl in. Even cash that is deposited over the counter to a bank teller can be held for 24 hours before becoming available to cover a transaction. The second business day rule for local checks means that a low-income worker who deposits a pay check on Friday afternoon will not get access to funds until the following Tuesday. If the paycheck is not local, it can be held for five business days. This long time period applies even when the check is written on the same bank where it is deposited. Consumers who deposit more than $5,000 in one day face an added wait of about five to six more business days. Banks refuse to cash checks for consumers who do not have equivalent funds already on deposit. The combination of unjustifiably long deposit holds and banks' refusal to cash account holders' checks pushes low income consumers towards check cashing outlets, where they must pay 2 to 4 percent of the value of the check to get immediate access to cash.

Consumer groups have called on the Federal Reserve to speed up deposit availability and to prohibit banks from imposing overdraft or NSF fees on transactions that would not have overdrawn if deposits had been available. The Federal Reserve vigorously supported Check 21 to speed up withdrawals but has refused to shorten deposit hold periods for consumers.

D. <u>The Federal Reserve has Supported the Position of Payday Lenders and Telemarketing Fraud Artists by Permitting Remotely Created Checks (Demand Drafts) to Subvert Consumer Rights Under the Electronic Funds Transfer Act</u>

In 2005, the National Association of Attorneys General, the National Consumer Law Center, Consumer Federation of America, Consumers Union, the National Association of Consumer Advocates, and U. S. Public Interest Research Group filed comments with the Federal Reserve in Docket No. R-1226, regarding proposed changes to Regulation CC with respect to demand drafts. Demand drafts are unsigned checks created by a third party to withdraw money from consumer bank accounts. State officials told the FRB that demand drafts are frequently used to perpetrate fraud on consumers and that the drafts should be eliminated in favor of electronic funds transfers that serve the same purpose and are covered by protections in the Electronic Funds Transfer Act. Fraudulent telemarketers increasingly rely on bank debits to get money from their victims. The Federal Trade Commission has reported that 25 percent of all fraud complaints received by the agency in 2004 involved a bank debit, an increase of 40 percent in just one year. Since automated clearinghouse transactions are easily traced, fraud artists prefer to use demand drafts.

Remotely created checks are also used by telemarketers and others to remove funds from checking accounts that receive the protections of the Electronic Funds Transfer Act. CFA issued a report on Internet payday lending in 2004 and documented that some high-cost lenders converted debts to demand drafts when consumers exercised their EFTA right to revoke authorization to electronically withdraw money from their bank accounts. CFA brought this to the attention of the Federal Reserve in 2005, 2006 and 2007. No action has been taken to safeguard consumers' bank accounts from unauthorized unsigned checks or conversion of an obligation from an electronic funds transfer to a demand draft to thwart EFTA protections.

E. <u>The Federal Reserve Has Taken No Action to Safeguard Bank Accounts from Internet Payday Lenders</u>

In 2006, consumer groups met with Federal Reserve staff to urge them to take regulatory action to protect consumers whose accounts were being electronically accessed by Internet payday lenders. We joined with other groups in a follow up letter in 2007, urging the Federal Reserve to make the following changes to Regulation E:

- Clarify that remotely created checks are covered by the Electronic Funds Transfer Act.
- Ensure that the debiting of consumers' accounts by internet payday lenders is subject to all the restrictions applicable to preauthorized electronic funds transfers.
- Prohibit multiple attempts to "present" an electronic debit.
- Prohibit the practice of charging consumers a fee to revoke authorization for preauthorized electronic funds transfers.
- Amend the Official Staff Interpretations to clarify that consumers need not be required to inform the payee in order to stop payment on preauthorized electronic transfers.

While FRB staff has been willing to discuss these issues, the FRB has taken no action to safeguard consumers when Internet payday lenders and other questionable creditors evade consumer protections or exploit gaps in the Electronic Funds Transfer Act to mount electronic assaults on consumers' bank accounts.

F. <u>The Banking Agencies Have Failed to Stop Banks From Imposing Unlawful Freezes on Accounts Containing Social Security and Other Funds Exempt from Garnishment</u>

Mr. Chairman, we applaud you for urging federal banking regulators to take action regarding recent reports that national banks are not complying with the Social Security Act's prohibition on the garnishment of Social Security and Veteran's benefits. These federal benefits (as well as state equivalents) are taxpayer dollars targeted to relieve poverty and ensure minimum subsistence income to the nation's workers. Despite the purposes of these benefits, banks routinely freeze bank accounts containing these benefits pursuant to garnishment or attachment orders, and assess expensive fees – especially insufficient fund (NSF) fees – against these accounts.

The number of people who are being harmed by these practices has escalated in recent years, largely due to the increase in the number of recipients whose benefits are electronically deposited into bank accounts. This is the result of the strong federal policy to encourage this in the Electronic Funds Transfer Act. And yet, the banking agencies have failed to issue appropriate guidance to ensure that the millions of federal benefit recipients receive the protections they are entitled to under federal law.

G. <u>The Comptroller of the Currency Permits Banks to Manipulate Payment Order to Extract Maximum Bounced Check and Overdraft Fees, Even When Overdrafts are Permitted</u>

The Comptroller of the Currency permits national banks to rig the order in which debits are processed. This practice increases the number of transactions that trigger an overdrawn account, resulting in higher fee income for banks. When banks began to face challenges in court to the practice of clearing debits according to the size of the debit -- from the largest to the smallest --rather than when the debit occurred or from smallest to largest check, the OCC issued guidelines that allow banks to use this dubious practice.

The OCC issued an Interpretive Letter allowing high-to-low check clearing when banks follow the OCC's considerations in adopting this policy. Those considerations include: the cost incurred by the bank in providing the service; the deterrence of misuse by customers of banking services; the enhancement of the competitive position of the bank in accordance with the bank's business plan and marketing strategy; and the maintenance of the safety and soundness of the institution.[30] None of the OCC's considerations relate to consumer protection.

The Office of Thrift Supervision (OTS) addressed manipulation of transaction-clearing rules in the Final Guidance on Thrift Overdraft Programs issued in 2005. The OTS, by contrast, advised thrifts that transaction-clearing rules (including check-clearing and batch debit processing) should not be administered unfairly or manipulated to inflate fees.[31] The Guidelines issued by the other federal regulatory agencies merely urged banks and credit unions to explain the impact of their transaction clearing policies. The Interagency "Best Practices" state: "Clearly explain to consumers that transactions may not be processed in the order in which they occurred, and that the order in which transactions are received by the institution and processed can affect the total amount of overdraft fees incurred by the consumers."[32]

CFA and other national consumer groups wrote to the Comptroller and other federal bank regulators in 2005 regarding the unfair trade practice of banks ordering withdrawals from high-to-low, while at the same time unilaterally permitting overdrafts for a fee. One of the OCC's "considerations" is that the overdraft policy should "deter misuse of bank services." Since banks deliberately program their computers to process withdrawals high-to-low and to permit customers to overdraw at the ATM and Point of Sale, there is no "misuse" to be deterred.

No federal bank regulator took steps to direct banks to change withdrawal order to benefit low-balance consumers or to stop the unfair practice of deliberately causing more transactions to bounce in order to charge high fees.

IV. The OCC's Consumer Assistance Efforts are Weak

A. The Consumer Assistance Group

The OCC's approach to handling consumer complaints against national banks is unfortunately illustrative of the agency's disappointing overall record in consumer protection. The OCC was established to supervise national banks and its primary focus continues to be on maintaining the safe and sound operation of these banks. However, the OCC also has been assigned important consumer protection responsibilities. Most notably, under the Federal Trade Commission Act, the agency is directed to protect consumers from unfair and deceptive practices by national banks. Further, enforcement of other applicable consumer protection, fair lending and community reinvestment laws and regulations is handled through the bank examination process.

Another consumer responsibility is the processing and disposition of consumer complaints against national banks. This function is largely handled through the OCC's Customer Assistance Group (CAG) which operates a single national call center in Houston, Texas. The

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[30] 12 C.F.R. 7.4002(b).
[31] Office of Thrift Supervision, Guidance on Overdraft Protection Programs, February 14, 2005, p. 15.
[32] Dept. of Treasury, Joint Guidance on Overdraft Protection Programs, February 15, 2005, p. 13.

agency's self-described approach to processing consumer complaints is one of a "neutral arbiter." Yet the CAG seems to primarily function as a channel for funneling consumer complaints to national banks. A 2006 U.S. General Accountability Office (GAO) report issued last year found that, as with the other banking regulators, the OCC resolves most of the complaints it receives mostly by providing clarifying information to bank customers.[33] The agency investigates or makes determinations about whether the customer or bank erred less frequently. The GAO report also found that while the OCC receives a greater volume of complaints than other regulators, it lacked a mechanism for gathering consumer feedback on how helpful they were.

CFA and other national consumer groups long have questioned the adequacy of the OCC's complaint system. Our concerns are heightened particularly by the agency's preemption rules that give it exclusive authority for supervising non-bank subsidiaries of national banks. This new authority exponentially increases the number of financial institutions that the OCC's complaint process now has primarily responsibility for handling.

The Houston complaint center historically has been understaffed and, for a time, was only open to the public for limited daily hours four days a week. Criticism from the Chairman and other committee members has prodded the OCC to take some steps aimed at addressing these concerns. For example, several years ago the OCC increased the number of full-time-equivalent CAG staff to fifty, more than doubling its previous staff. However, even this expanded staff still represents less than two percent of the OCC's total workforce of more than 2,800 employees (1,900 of which serve as bank examiners).

The CAG service hours also were increased from 7 to 12 hours a day and we understand that the Houston office now operates a full five-day schedule. (The agency says that the expanded service hours require it to use a third-party vendor to provide initial intake on complaints). Just weeks ago, the OCC finally redesigned the consumer complaint website.

Last year, CFA staff visited the Houston call center. We were impressed with the professionalism of the CAG staff we met that day. Yet we were disappointed to learn that the information collected from consumer complaints are apparently used only at the case-specific level. Agency officials indicated that complaints against specific national banks were sometimes used in developing upcoming compliance exams. However, no concrete examples were provided of instances in which the agency analyzed the overall pattern of complaints against varying institutions and utilized the complaints it received to develop new regulatory guidance or issue new rules for national banks.

In short, the OCC's record is as passive in providing consumer assistance as it is in other areas of consumer enforcement.

B. Consumer Assistance Website

[33] U.S. Accountability Office, "OCC Consumer Assistance: Process is Similar to That of Other Regulators but Could Be Improved by Enhanced Outreach," GAO-06-293 (February 2006).

Just last week, OCC rolled out a new website (http://www.helpwithmybank.gov/) with fanfare, as a tool for consumers with questions or concerns about their bank.[34] Unfortunately, there is less there than meets the eye in both cases. Indeed, a review of the FAQs on the new "Help" site concerning some of the issues that are most problematic for consumers today suggest that it is possible that the site itself may actually discourage consumers from making complaints. For example, on the issue of manipulating payment order of debits to maximize fees, a problem discussed above, here is what the "Help With My Bank" site says:

> My bank paid my largest check first and then the smaller ones. Doing so created more overdraft fees on my account. Why did the bank pay in this order?
>
>> You may write your checks in numerical order, but that doesn't mean the bank will post them that way. The same is true with point-of-sale or other electronic transactions: They don't necessarily post in the order in which you made the purchases.
>>
>> When several items come to the bank for clearing, it can choose to debit them from your account in several ways. Many national banks are opting to post the largest dollar items first instead of posting the checks in numerical order. Often the largest check represents payment for rent, mortgage, car payments, or insurance premiums.
>>
>> If your bank adopts this policy throughout its territory, it normally will notify you via your statement.

Another bank practice which increasingly has been attracting attention is the institutions' encouragement of overdrafts to maximize their revenues.[35] Indeed, banks advertise the ability to have overdrafts covered, seducing their customers into taking advantage of that "convenience." Yet here is what the OCC says to the consumer:

> I wrote a check that was returned because of insufficient funds (NSF) in my account. But the bank never notified me, so other checks bounced and I got hit with several overdraft fees. Shouldn't the bank have sent me a notice?
>
>> The bank is not required to notify you when a check bounces. You are responsible for keeping a current and accurate check/transaction register. By balancing it with your monthly statement, you will know your account balance and prevent overdrafts.
>>
>> State laws generally provide that it is illegal to write a check—knowingly or negligently—without having sufficient funds to cover the check *on the day you write it.*

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[34] " *Comptroller of the Currency Launches Web Site to Help National Bank Customers,*" NR-2007-73 (July 17, 2007), ,http://www.occ.treas.gov/ftp/release/2007-73.htm.

[35] *See, e.g.* Eric Halperin and Peter Smith, *Out of Balance: Consumers Pay $17.5 Billion Per Year in Fees for Abusive Overdraft Loans,"* Center for Responsible Lending (July 11, 2007), http://www.responsiblelending.org/pdfs/out-of-balance-report-7-10-final.pdf.

And for consumers who do try to keep their checkbook balanced and up-to-date, in accordance with the OCC's suggestion? Here's the OCC's advice:

> How can my account be overdrawn when I just made a deposit?
>
> Many transactions are processed overnight. These transactions may not be reflected in an available balance.
>
> Thus it's important to keep a current and accurate check/transaction register and balance it to your monthly statement. A bank's online, telephone, or ATM balances are for information purposes only—they do *not* replace your check/transaction register.
>
> On checking accounts, banks generally post deposits before withdrawals. However, there are no laws requiring national banks to do this. In addition, banks may establish a cutoff time for deposits made at a branch or through an ATM. Deposits made after that time may be treated as having been made on the following business day.
>
> For example, a deposit made after the Friday afternoon cutoff time would be treated as if it were made on the following Monday. So any items with next-day availability would then be available the next day (Tuesday).

But can the bank still charge the overdraft fee in that case?

> Can the bank charge an overdraft fee while there is a deposit pending?
>
> Yes. Many transactions are processed overnight. These transactions may not be reflected in an available balance.
>
> This is why it's important to keep a current and accurate check/transaction register and balance it to your monthly statement. A bank's online, telephone, or ATM balances are for information purposes only—they do *not* replace your check/transaction register.
>
> On checking accounts, banks generally post deposits before withdrawals. However, the law does not require this. In addition, banks may establish a cutoff time for deposits made at a branch or through an ATM. Deposits made after that time may be treated as having been made on the following business day.
>
> For example, a deposit made after the Friday afternoon cutoff time would be treated as if it were made on the following Monday. So any items with next-day availability would then be available the next day (Tuesday).

A consumer victimized by multiple overdraft fees could be forgiven for taking away this message: "There's no point in complaining, because the bank can do whatever it wants."

Consumers, advocates and state regulators have long noticed that card issuers are either themselves ignorant of, or do not honor, special rights that consumers have when they have a dispute with a merchant over goods or services purchased with a credit card. This right allows consumers to assert the claims and defenses arising out of a credit card purchase of goods or services against the card issuer.[36] The rules for asserting these claims are different than the standard "billing error" rights.[37] We were unable to find any reference at all to this important consumer right in the portion of the "Help With My Bank" section labeled "credit cards dispute."

If, on balance, the overall message of the new website is that there's not much point in filing a complaint, there is also little heart to be taken from the complaint process itself. Apart from the question of whether the resources are adequate, the consumer complaint page on the OCC's website discourages consumers from complaining about situations which, it should be hoped, the OCC would most want to be made aware of: the possibility that a bank was engaging repeatedly in misrepresentations or violations of contractual obligations. Yet the website discourages consumers from do so, instead simply telling them to get a lawyer:[38]

> **When You Need Other Help**
>
> Many complaints stem from factual or contract disputes between the bank and the customer. Only a court of law can resolve those disputes and award damages. If your case involves such a dispute, we will suggest that you consult an attorney for assistance.

Assuming that the consumer does file a complaint, despite all this discouragement, the OCC now explains that it would be illegal for them to tell the consumer if the bank violated the law with respect to the action about which the consumer complained.

> Can the OCC help me find out if a bank has been cited for a violation of a regulation or law?
>
> > According to Federal law, results of examinations are considered confidential. The OCC cannot release any information relating to any supervisory actions *or regarding whether a violation of law or regulation occurred in connection with your complaint*. [**emphasis added**]
> > However, you can look for two kinds of information on our Web site, www.occ.gov:
> >
> > - whether a bank is in compliance with the Community Reinvestment Act (CRA)
> > - whether a bank is subject to an enforcement action[39]

It is possible that the OCC's overall discouraging approach to hearing complaints about their banks reflects the poor odds that it would do the consumer any good to make the effort. Results from a GAO study indicate that customer complaints are rarely resolved in the

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[36] 15 U.S.C. § 1666i; Reg. Z, § 226.12(c)

[37] 15 U.S.C. § 1666, Reg. Z, § 226.13. For example, there is a 60-day time limit for the consumer to dispute a billing error. There is no flat 60-day time limit for the merchant-related dispute, though there are other restrictions.

[38] http://www.occ.treas.gov/customer.htm#The%20OCC's%20Complaint%20Process.

[39] http://www.helpwithmybank.gov/faqs/other_occ_help.html#drop02.

consumer's favor.[40] Overall, the message from the OCC to consumers seems to be, "you're on your own."

V. "Principles-Based" Regulation Leaves Consumers Vulnerable to Lax Enforcement

Some federal regulators have contended that their unwillingness to adopt regulations proscribing specific unfair and deceptive practices that are forbidden in the Federal Trade Commission (FTC) Act and Home Ownership and Equity Protection Act (HOEPA) is actually an advantage for consumers, allowing regulators to nimbly apply broad-based legal requirements on a case-by-case basis. Such case-by-case enforcement based on broad legal principals, they say, makes it more difficult for financial institutions to maintain technical compliance with the letter of the law, while violating its spirit.[41]

In our experience, industry representatives who advocate a principles-based approach to regulation often have weakened consumer protections as their real goal. That certainly appears to be the case in recent calls to adopt a principles-based approach to securities regulation as a way to make our securities markets more competitive internationally. Moreover, in practice, the principles-based approach has been shown to have inherent weaknesses that more than outweigh the purported advantages of streamlined rules and greater regulatory flexibility.

Ideally, under a principles-based approach, regulations clearly define the outcome regulated entities are expected to achieve, and regulators hold them accountable for achieving that outcome. Under such an approach, one could in theory hold a company accountable for filing financial statements that fail to fairly present the company's financial status, or hold a bank accountable for misleading borrowers, for example, without having to prove that any rule was broken. Aggressively implemented, such an approach could in theory provide for effective consumer protection regulation.

There are several problems with this approach, however. One is that it relies on regulators to be far more aggressive in holding companies accountable than the banking regulators have shown themselves to be. A second problem is that it moves decisions about what constitutes non-compliant behavior out of the relatively transparent public rulemaking process into backroom negotiations between the regulator and the regulated entity. Observation of the United Kingdom's experiment with principles-based regulation suggests that the likely result of making decisions about the enforcement of regulatory policy behind closed doors will be lax enforcement.

If, on the contrary, regulators were to attempt to adopt a tough approach to enforcement

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[40] Referring to a 2006 GAO Review of "OCC Consumer Assistance," (GAO-06-293): "What stands out in the 41-page report is that bank regulators rarely stick up for the consumer." Gail Liberman and Alan Lavine, *Regulators RarelyBlame Banks,"* MarketWatch, (April 3, 2006), http://www.marketwatch.com/

[41] "To be effective, rules must have broad enough coverage to encompass a wide variety of circumstances so that they are not easily circumvented. At the same time, rules with broad prohibitions could limit consumers' financing options in legitimate cases that do not meet the required legal standard. That has led the Federal Reserve to focus primarily on addressing potentially unfair or deceptive practices by using its supervisory powers on a case-by-case basis rather than through rulemaking." Statement of Randall S. Kroszner, Member, Board of Governors of the Federal Reserve System before the Committee on Financial Services, U.S. House of Representatives, June 13, 2007.

under a principles-based regulatory regime, the lack of clarity in the principles-based approach is likely to result in a large number of disputes between the regulator and regulated entities. In such cases, the task of interpreting regulations may ultimately fall to the courts. That has the disadvantage of being both costly and time-consuming, and of removing decisions about the best approach to regulation from the expert regulators.

The recent forays into principles-based regulation in the securities area suggests another potential problem – the lack of principle in principles-based regulation. Both the recently revised management guidance on Section 404 of the Sarbanes-Oxley Act, and the revised audit standard for internal controls audit, have been touted as adopting a principles-based approach to regulation. However, neither the management guidance nor the proposed audit standard is founded on clearly articulated principles that managers and auditors could be held accountable for achieving. Instead, they spend a great deal of time explaining what managers and auditors will not be held accountable for failing to do. If this is an example of what we can expect of principles-based financial services regulation, our skepticism regarding this approach seems more than justified.

Finally, those who call for principles-based regulation typically ignore both the degree to which our rules-based system is founded on strong underlying principles and the degree to which principles-based systems must rely on "guidance" to provide clarity that the principles alone cannot convey. Ironically, the same parties who have advocated a more principles-based approach to securities regulation have also argued for greater clarity in two areas where a principles-based approach has been adopted – the definitions of materiality and scienter. This further illustrates what we found to be the case – that the support for principles-based regulation tends to be more theoretical than real, and that the last thing most regulated entities want is a regulatory system that defines general consumer protection principles and holds them accountable when they fail to achieve them.

VI. Identifying the Underlying Causes of Federal Regulatory Failures

It would be easy to blame the federal regulatory failures in the credit practices arena solely on the lack of legal or enforcement authority for federal banking agencies, but this would not be true. Although our groups do recommend that Congress enact new consumer protection laws, especially regarding credit card abuses, and that it increase the legal jurisdiction granted to the FTC in the credit arena, underlying problems that have caused poor federal enforcement will not be solved simply by giving new authority to the same banking agencies.

Most of the regulatory failures cited above are in areas where federal regulators have existing authority to act, and have chosen not to do so. Simply increasing the authority of the agencies to write or enforce rules, or to offer a unified complaint hotline, will not change the culture in some agencies that has caused them to ignore festering problems in the credit arena or to reject adequate consumer protection measures. In fact, by raising expectations of reform and then not following through, such changes could actually be harmful by impeding meaningful reform. In order to fashion effective federal remedies consistent with the above consumer protection standards, the underlying problems with the regulatory culture at the federal banking agencies must also be addressed. These problems include:

1. **An overwhelming focus on safety and soundness regulation, often to the exclusion of consumer protection**. All four of the primary banking regulatory agencies examine and supervise banks.[42] A major focus of this supervision is the financial safety and soundness of the institutions. These agencies are also charged with enforcing consumer protection laws that affect the institutions they supervise, but in many cases do not appear to make consumer protection a significant budget or strategic priority.[43] The obvious problem with vesting both safety and soundness and consumer protection with a single agency is that the agency might well view the two goals as in conflict or place too high a priority on safety and soundness enforcement.[44] As illustrated above regarding the FRB's inaction on bounce loans, an agency focused almost exclusively on what is financially beneficial for banks would likely view a restriction on bank loan income as a threat to the bank's financial stability, even if the practice in question is financially harmful to consumers.

2. **Significant funding from industry sources represents a major conflict-of-interest**. None of the banking agencies receive appropriated funds from Congress. The OCC and OTS receive virtually all of their income from direct assessments on the institutions they supervise. The FDIC is funded by premiums that banks and thrift institutions pay for deposit insurance coverage and from earnings on investments in Treasury securities. The Federal Reserve System receives the greatest portion of its income from interest earned on government securities, but it does receive substantial income from what it calls "priced services to depository institutions," bank examinations, inspections and risk assessments of bank holding companies.[45]

   Given that it supervises the largest financial institutions in the country, the OCC's funding situation is the most troublesome. (See Appendix C for more information on the OCC's funding, conflicts-of-interest and regulatory failures.) As highlighted above, the OCC has not initiated a public enforcement order against any of the eight largest national banks for violating consumer credit laws since early 1995. As Professor Arthur Wilmarth said in his testimony before the Financial Institutions and Consumer Credit Subcommittee:

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[42] The OCC and OTC charter and supervise national banks, and thrifts, respectively. State chartered banks can choose whether to join and be examined and supervised by either the Federal Reserve System or the Federal Deposit Insurance Corporation (FDIC). The FTC is charged with regulating some financial practices in the non-bank sector, such as credit cards offered by department stores and other retailer.

[43] The OTS, for example, cites consumer protection as part of its "mission statement" and "strategic goals and vision." However, in identifying its eight "strategic priorities" for how it will spend its budget in Fiscal Year 2007, only part of one of these priorities appears to be directly related to consumer protection ("data breaches"). On the other hand, OTS identifies both "Regulatory Burden Reduction" and "Promotion of the Thrift Charter" as major strategic budget priorities. Office of Thrift Supervision, "OMB FY2007 Budget and Performance Plan," January 2007.

[44] Safety and soundness concerns at times can lead to consumer protection, as in the eventually successful efforts by federal banking agencies to prohibit "rent-a-charter" payday lending, in which payday loan companies partnered with national or out-of-state banks in an effort to skirt restrictive state laws. However, from a consumer protection point-of-view, this multi-year process took far too long. Moreover, the outcome could have been different if the agencies had concluded that payday lending would be profitable for banks and thus contribute to their soundness.

[45] In 2006, this income was $909 million. "Federal Reserve Release," January 9, 2007. This amount was about one-third of the just under $3 billion in operating costs for the entire Federal Reserve System. Board of Governors of the Federal Reserve System, "Annual Report: Budget Review," April 2007.

> More than 95% of the OCC's budget is financed by assessments paid by national banks, and the twenty biggest national banks account for nearly three-fifths of those assessments. Large, multi-state banks were among the most outspoken supporters of the OCC's preemption regulations and were widely viewed as the primary beneficiaries of those rules. In addition to its preemption regulations, the OCC has frequently filed amicus briefs in federal court cases to support the efforts of national banks to obtain court decisions preempting state laws. The OCC's effort to attract large, multi-state banks to the national system have already paid handsome dividends to the agency….Thus, the OCC has a powerful financial interest in pleasing its largest regulated constituents, and the OCC therefore faces a clear conflict of interest whenever it considers the possibility of taking an enforcement action against a major national bank.[46]

3. **Regulatory balkanization leads to downward pressure on consumer protections, often resulting in "lowest common denominator" regulation. On the other hand, when agencies do collaborate to raise standards, the process can take so long as to make eventual regulatory action far less helpful for consumers.** The present regulatory system for credit practices is institution-centered, rather than consumer-centered. It is structured according to increasingly irrelevant distinctions between the type of institution that is lending money, rather than the type of product being offered to consumers. Agency charter "shopping" is not a viable option in most cases for national banks, but it can be for thrifts and for state chartered banks, which can and do choose between supervision by the Federal Reserve system and the FDIC[47] and, as explained above, between a state and national charter. Regulators often appear to be more concerned that the requirements they place on the institutions they regulate – even if highly justified for consumer protection purposes – might be viewed by these institutions as a "regulatory burden." All of the banking agencies cite "reducing regulatory burden" as a priority and often appear to compete to do so, even if it means that important protections are reduced.

When agencies do collaborate to apply consumer protections consistently to the institutions they regulate, the process can be staggeringly slow. For example, as credit card debt loads began to increase for Americans in the mid and late 1990s, consumer organizations and credit experts began to issue serious warnings that the lower minimum payment amounts that all credit card issuers were offering their cardholders were contributing to the sharp increase in the number of consumer bankruptcies.48 It wasn't until January 2003 that regulators issued guidance recommending that credit card lenders increase the size of the minimum payment amounts so that consumers would "amortize the current balance over a reasonable period of time," noting that prolonged negative amortization would be subject to bank examiner

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[46] Testimony of Arthur E. Wilmarth, Jr., Professor of Law, George Washington University Law School, House Financial Services Subcommittee on Financial Institutions and Consumer Credit, April 26, 2007.
[47] For example, the First Bank of Delaware dropped its Federal Reserve member bank status and switched to supervision by the FDIC to continue its rent-a-bank payday lending operation.
[48] Day, Kathleen and Caroline E. Mayer, "Credit Card Penalties, Fees Bury Debtors," *Washington Post*, March 6, 2005.

criticism.49 Issuers were not required to fully phase in the changes until the end of 2006, close to a decade after initial concerns were raised. Another obvious example of a sluggish regulatory process that has harmed consumers is the federal delay in issuing regulations to deal with the serious and well-publicized problems in the sub-prime mortgage lending market.

4. **An undue focus on bank examination instead of enforcement, which lacks transparency and effectiveness.** Bank regulators have said repeatedly to this Committee and others that the process of supervision and examination results in a superior level of consumer protection to taking enforcement action against institutions that violate laws or rules. For example, Comptroller of the Currency John Dugan told this Committee on June 13th that "…ours is not an 'enforcement-only' compliance regime – far better to describe our approach as "'supervision first, enforcement if necessary,' with supervision addressing so many early problems that enforcement is not necessary."[50] Given the widespread consumer abuses in the credit card market documented above and the OCC's ineffectual regulation of national banks like Providian that committed these abuses, this claim is simply not supported by the facts.

   There is another serious problem with relying almost exclusively on the examination process to require national banks to comply with laws and regulations: the process is highly discretionary and not open to public view.

> Findings made during compliance examinations are strictly confidential and are not made available to the public except at the OCC's discretion. Similarly, the OCC is not required to publish the results of its safety-and-soundness orders….Thus, the OCC's procedures for compliance examinations and safety-and-soundness orders do not appear to provide any public notice or other recourse to consumers who have been injured by violations identified by the OCC.[51]

At best, these factors combine to create a culture of coziness with regulated institutions at many of the agencies. At worst, as in the case of the OCC, they appear to have led to regulatory capture.

VII. Recommendations

All of our recommendations are directed at creating a more independent enforcement and regulatory process that is more focused on consumer protection. Unless the underlying causes of federal regulatory failures are addressed to achieve greater independence from regulated institutions and to grant more power to consumers to enforce the law, protections for consumers will not improve. Greater regulatory independence will also mean that some of the meritorious

[49] Joint Press release of Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency and Office of Thrift Supervision, "FFIEC Agencies Issue Guidance on Credit Card Account Management and Loss Allowance Practices," January 8, 2003, see attached "account Management and Loss Allowance Guidance" at 3.

[50] Testimony of John C. Dugan, Comptroller of the Currency, Before the Committee on Financial Services of the U.S. House of Representatives," June 13, 2007.

[51] Testimony of Arthur E. Wilmarth, Jr., Professor of Law, George Washington University Law School, House Financial Services Subcommittee on Financial Institutions and Consumer Credit, April 26, 2007.

ideas that the Committee has been considering that are not mentioned below, such as a "one stop shopping" process for consumer complaints, will be implemented in an effective manner.

1. **Restore the Ability of the States to Protect Consumers in the Credit Arena.** As it stands now, OCC rules prevent enforcement of many state consumer protections against national banks and their subsidiaries. Banks even maintain that these stronger state laws are preempted when they are based on Congressional statutes that specifically permit states to provide protections beyond those in the federal law. The OCC rules also preempt the performance of essential functions of state officials to protect state citizens and defy over a century of jurisprudence holding that state officers can enforce a broad set of laws against national banks. Historically, these protective actions have covered both the individual bad acts of national banks, as well as bank policies that are deemed to be unfair or deceptive to consumers.

   This is why national consumer organizations favor the approach taken by "The Preservation of Federalism in Banking Act" (H.R. 1996) introduced earlier this year by Representative Luis Gutierrez. We have previously supported legislation along these lines offered by the by the Chairman and Mr. Gutierrez in the last Congress and believe that this bill is particularly necessary and relevant in light of the Watters decision.

   H.R. 1996 establishes much needed standards governing the relationship between state consumer authority and the operation of national banks and their subsidiaries. The bill also covers federal thrifts, as the Office of Thrift Supervision has from time-to-time sought to broaden the scope of federal preemption to new entities, such as independent third party agents of thrifts.

   H.R. 1996 directs federal regulators to distinguish between preempted state laws affecting the business of banking and the powers of national banks and thrifts, as well as permissible state laws of general applicability protecting consumers. The bill also prevents federal preemption from diminishing the ability of states to protect their consumers from fraudulent, deceptive and predatory banking practices. Frequently, no corresponding federal protections exist when the OCC preempts state laws, and thus consumers are deprived of protections currently available to them. Other key provisions in the bill would clarify the visitorial rights of state officials seeking to enforce applicable federal or state laws and reinstate state authority over non-bank operating subsidiaries. Finally, the bill makes clear that the National Bank Act is not intended to bar a state's ability to enact stronger laws regulating national banks when those laws are based on clear Congressional intent of other federal laws to serve as a floor and not a ceiling for consumer protections.

   We urge the committee to hold hearings on this legislation.

2. **Enact legislation to establish high consumer protection standards for credit card, bank overdraft and mortgage loans.** Take legislative action to protect consumers where bank regulators have failed to do so, such as the FRB's unwillingness to apply TILA protections to overdraft loans. We urge Congress to adopt legislation introduced

by Representative Maloney (H.R. 946) that would require that consumers who receive overdraft loans benefit from the same protections under TILA as they would for other loans. (See also the attached credit card reform platform in Appendix A and the principles for enacting mortgage lending reforms in Appendix B.)

3. **Authorize the Federal Trade Commission to bring enforcement actions against national banks and thrifts for unfair and deceptive practices. Give the FTC concurrent and independent rulemaking authority over national banks and thrifts for all matters covered by the FTC Act.** Unlike the banking agencies, the FTC has no responsibility to protect the profitability of financial institutions. Its sole job is, or should be, to protect consumers from the unlawful and deceptive practices prohibited by the FTC Act. And yet, the FTC Act deprives the FTC of the essential authority over regulated institutions. The FTC has extensive experience dealing with unfair and deceptive practices by non-bank entities. In light of the failure of the FRB to use its authority under the FTC Act, the FTC should be given concurrent authority both to bring enforcement actions and to engage in rulemaking. This authority would be consistent with the independent authority that state attorneys general have regarding state chartered banks in some states. This is not to say that giving authority to the FTC will be a perfect solution. The FTC's record in recent years with respect to non-bank entities is less than perfect, and Congress may need to make clear to the FTC that it will gain this authority only if it commits to using it in an appropriate fashion. However, the FTC lacks the inherent conflict of interest that paralyzes some of the banking agencies, and it is appropriate for the agency to have full authority under the FTC Act over all entities that engage in unfair and deceptive practices.

4. **Grant states concurrent enforcement authority against national banks and thrifts under federal lending laws and for unfair and deceptive practices under the FTC Act.** This approach will help put state enforcement officials, including banking regulators, back "on the beat." The model for this approach would be the concurrent enforcement authority granted to states under such federal laws as the Telemarketing Sales Act[52] and the Credit Repair Organizations Act.[53] This approach would lead to more vigorous enforcement, and in particular would foster attention to emerging problems that have not yet become national in scope.

5. **Provide consumers with a private right-of-action under the FTC Act.** At present, the essential protection in the FTC Act against unfair and deceptive practices is not privately enforceable. Yet, individuals are obviously in the best position to invoke the Act in response to individual violations. Even strong federal agency enforcement against widespread abuses would not help consumers who confront individual abuses. Although most states have parallel protections, in many states consumers cannot bring claims under the state deceptive practices statute against banks or other financial institutions. In some states, the deceptive practices statute explicitly excludes these entities. In other states, courts have interpreted the statute to exclude them (often construing an exemption for

[52] 15 U.S.C. § 6103 (giving state Attorneys General concurrent authority with FTC to enforce Telemarketing Sales Rule, 12 C.F.R. § 310).
[53] 15 U.S.C. § 1679h (giving state Attorneys General and FTC concurrent enforcement authority).

"regulated practices" to exclude any activity by a regulated financial institution, not just specific practices authorized by banking regulations). Another weakness of state deceptive practices laws is that many prohibit only deceptive practices, not unfair practices, or define the prohibited practices very narrowly.[54] As a result, in many states consumers have very limited remedies for unfair or deceptive practices by financial institutions. Public enforcement does not fill this gap. Even if state Attorneys General and the FTC were granted enforcement authority, their resources are limited and they have to concentrate on cases with broad impact, rather than on obtaining justice for individual consumers.

6. **Reduce conflicts-of-interest between regulators and regulated institutions. Consider requiring federal banking agencies to pool funds collected for supervision, examination and consumer protection.** We would urge the Committee to consider establishing an independent, inter-agency process that receives input from consumer representatives, to distribute the funds to banking agencies based on need.

7. **Require agencies to conduct periodic reviews of the effectiveness of consumer protection rules and enforcement efforts.** Federal agencies must meet statutory requirements regarding the reduction of regulatory burdens and "paperwork" on regulated industries, but no such requirement exists for consumer protection. We urge the Committee to enact legislation that would require banking regulators to regularly investigate key emerging consumer issues and concerns and to make recommendations to Congress regarding changes in supervision, regulation and law that should be made. The agencies should be required to consult consumer representatives, state regulators, Attorneys General as part of this review.

8. **Evaluate industry proposals for "principles-based" regulation with great Skepticism.** All regulations should be founded on strong underlying principles, but we urge you to skeptically view calls by representatives of the financial services industry for principles-based regulation. There is overwhelming evidence that many consumers have been harmed by unfair and deceptive practices in a number of credit markets. As stated above, the OCC and FRB appear to have taken what is essentially a "principles based" approach in protecting consumers for a number of years. It stretches the bounds of credulity to claim this approach has been effective for financial services consumers.

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[54] In addition, federally-regulated financial institutions are increasingly claiming that state deceptive practices statutes are preempted by federal law (although many courts have rejected this argument).

APPENDIX A

ACORN * Center for Consumer Finances * Consumer Action * Consumers Union
Consumer Federation of America * Demos * National Association of Consumer Advocates * National Consumer Law Center • U.S. PIRG

Joint Recommendations of Consumer Groups on the Eve of the Jan. 25, 2007 U.S. Senate Banking Committee Oversight Hearing on Unfair Credit Card Practices

Eliminate reckless and abusive lending by credit card companies

No unsound loans. Make issuers offer credit the old fashioned way, using sound underwriting principles based on the ability of consumers to pay and that ensure the cardholder is not overextending financially by taking on more debt.

Restrict lending to youth without conditions. Young people deserve credit, but only if they qualify. Yet right now, young people are the only group that can obtain a credit card without either a positive credit report, a job, or other evidence of ability to pay, or, barring any of these, a co-signer. No other adult can get a credit card without meeting at least one of these conditions. Young people should have the same safeguards.

No abuse of consumers in bankruptcy. Credit card issuers drive consumers into bankruptcy with abusive terms and collection practices. Stop issuers from collecting on these abusive loans in bankruptcy.

End deceptive and unjust terms, interest rates and fees

Ban retroactive rate increases. Stop issuers from changing the rules in the middle of the game by raising interest rates on past purchases.

No unilateral adverse changes in terms for no reason. Credit card company contracts currently claim the right to change terms for any reason, including no reason. Any change in terms during the course of the contract should require knowing affirmative consumer consent and reasonable notice.

Ban universal default in all its forms. Prohibit punitive "universal default" interest rates based on alleged missteps with another issuer but involving no missed payments to the credit card company itself. It is unfair to impose a penalty rate on a consumer who has not made a late payment to that creditor. Stop card companies from using a change in terms clause to impose penalty rates.

Stop late fees for payments mailed on time. Require credit card companies to follow the Internal Revenue Service (IRS) and accept the postmarked date as proof of on-time payments. This will also eliminate the tawdry practice of assessing late payment fees when payment is received on the due date, because it did not arrive by a specific time (such as 11 a.m.).

Relate fees to cost. Ensure that all fees and other charges closely match the true cost borne by the card issuer.

End roll-over or repeat late and over-limit fees. Ban fees that are charged in consecutive months based on a previous late or over the limit transaction, not on a new or additional transaction offense, even if the consumer remains over the previous limit.

No fees for creditor-approved transactions. Don't let the credit card company charge a fee for a transaction it has approved. Ban over-limit fees when the issuer approves the over-limit transaction.

Empower consumers with more detailed information.

Ban deceptive credit card offers. Solicitations and "invitation to apply" solicitations that do not make a truly firm offer of credit are deceptive because they lead consumers to believe that they are pre-approved for or have a good chance of getting certain interest rates. Most consumers instead receive cards at much less favorable interest rates and terms.

Simplify pricing. Reduce the number and types of fees so consumers can compare cards and understand the real cost of using the card.

Real minimum payment warning. Give each consumer a personalized warning on his or her monthly statement calculating the length of time—in months and years—and the total interest costs that will accrue, if the consumer makes only the requested minimum payment.

Ban unfair teasers. Stop issuers from downplaying permanent interest rates in advertisements and solicitations and from trumpeting temporary rates as "fixed rates."

Enhance 'Schumer Box' disclosures. Include a "Schumer box" disclosure table in all cardholder agreements containing personalized information about the terms of the card granted. The box should include the APR, the credit limit, and the amount of all fees, such as late charges, cash advance fees, over limit fees and any other applicable miscellaneous fees.

Give consumers strong protections to deter illegal acts

Ban pre-dispute binding mandatory arbitration. No consumer should be forced to waive his or her right to a court trial as a condition of using a credit card. Prohibit binding mandatory arbitration for consumers' claims *and* for collection actions against consumers.

Toughen Truth In Lending Act (TILA) penalties. TILA penalties have stagnated since 1968.

Give aggrieved consumers a private right of action to enforce the Federal Trade Commission Act to challenge unfair or deceptive practices by businesses, including banks.

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ACORN, Jordan Ash, 651-503-4555
Center for Consumer Finances, Rochester Institute of Technology, Robert Manning, 585-475-4342
Consumer Action, Linda Sherry, 202-588-3440
Consumers Union, Norma Garcia, 415-431-6747
Consumer Federation of America, Travis Plunkett, 202-387-6121
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National Association of Consumer Advocates, Ira Rheingold, (202) 452-1989
National Consumer Law Center, Alys Cohen, 202-452-6252
U.S. PIRG, Ed Mierzwinski, 202-546-9707
February 6, 2007

APPENDIX B

The Honorable Barney Frank
Chairman
House Financial Services Committee

The Honorable Spencer Bachus
Ranking Member
House Financial Services Committee

The Honorable Chris Dodd
Chairman
Senate Banking Committee

The Honorable Richard Shelby
Ranking Member
Senate Banking Committee

Dear Chairman Dodd, Chairman Frank, Ranking Member Shelby, and Ranking Member Bachus:

Homeownership is the most accessible tool available to help families achieve a secure economic future, but today market failures and abusive lending practices are stripping the benefits of homeownership from millions of families **throughout the mortgage market.** The epidemic of home losses on subprime mortgages—as many as one in five— is a wake-up call, providing strong evidence that the current system of mortgage regulation is seriously flawed. To preserve homeownership for American families, we need real, systemic change embodied in policies that protect the **sustainability of homeownership**. Below, we outline a policy framework that would drive effective solutions to preserve the traditional benefits of owning a home. Our views represent those of many consumer, civil rights, and community groups, as well as a number of responsible mortgage lenders.

As Congress begins a new session, we respectfully ask that any new anti-predatory lending legislation be based on the following principles:

- **Restore sensible underwriting and eliminate unsustainable loans;**
- **Eliminate incentives for lenders to steer borrowers to abusive loans;**
- **Require accurate and accountable loan servicing;**
- **Ensure effective rights and remedies for families caught in predatory loans;**
- **Preserve essential federal and state consumer safeguards; and**
- **Reduce foreclosures through assistance to distressed borrowers.**

S**ustainable loans.** <u>Many lenders have abandoned careful lending standards to make loans that borrowers cannot repay without refinancing or selling their home</u>. As a result of this weak underwriting, an increasing number of homeowners are unable to keep up with their mortgage payments. High-risk adjustable rate mortgages (ARMs), which are underwritten to a low teaser payment instead of to the fully indexed rate, are an example of this problem. Studies show that today's subprime mortgages typically include features that increase the chance of foreclosure *regardless of the borrower's credit.* This has caused many families to default on unnecessarily risky loans and lose their homes. Other families are forced to refinance and pay associated fees or sell their home. *Responsible lending demands a realistic analysis of the borrower's ability to repay the loan based on all its terms*.

Incentives for fair loans. <u>The subprime market now rewards lenders and brokers who charge borrowers excessive points and fees or channel them toward riskier loan products</u>. Unknown to most borrowers, brokers receive payments known as "yield spread premiums" for selling loans at a higher interest rate than the lender requires. Most subprime mortgages also include prepayment penalties, which can cost families thousands of dollars when they refinance or pay off their loans early. Too often the borrower does not receive a lower interest rate in exchange for the prepayment penalty. In the inefficient subprime market, prepayment penalties are simply another method of stripping home equity or trapping borrowers in costly loans. These fees are only appropriate when they are in exchange for a real benefit to the borrower. A law to sustain homeownership must prohibit brokers and lenders from steering borrowers into mortgages with excessive costs.

Accountable loan servicing. <u>Companies that collect payments on mortgages—loan servicers—have tremendous influence on the success of the loan</u>. Servicer errors and unfair practices in recent years have contributed to the recent surge in foreclosures. Problems typically arise when loan servicers impose costly and unnecessary hazard insurance or delay crediting mortgage payments so that they can charge costly late fees to the homeowner. As it stands now, mortgage servicers have incentives to profit from loan defaults. In a healthy and truly competitive market, loan servicers would charge reasonable fees and support homeowners' efforts to avoid foreclosure.

Basic rights and remedies. <u>Victims of abusive lending practices have very little recourse because industry often uses its market power to limit homeowners' access to justice</u>. To be effective, consumer protection laws must: (1) give families a private right of action, the right to pursue class actions, and defenses against collection and foreclosure, which are often the only effective way to deter bad actors; (2) contain strong remedies and penalties for abusive acts; (3) provide effective assignee liability so that borrowers can pursue legitimate claims even when the originator has sold their loan; and (4) prohibit mandatory arbitration clauses that weaken victims' legal rights and deny them access to seeking justice in a court of law. Without these fundamental procedural protections, other consumer protection rules are unenforceable.

Preserve and advance existing protections. Current laws contain certain essential consumer protections designed to address some of the egregious practices in the mortgage industry, and these protections must be preserved. In particular, the majority of states have passed laws that have been highly effective in curbing abusive lending practices without hampering borrowers' access to credit. Any new law must build on these protections, bearing in mind that real estate markets vary significantly in different locations, and that states are in the strongest position to address new lending abuses that evolve over time. Legislative solutions must also preserve protections for families outside the mainstream real estate market—for example, those who use alternative ownership options such as mobile and manufactured housing and seller-driven financing; are credit impaired; have limited or no credit histories; have limited English skills; or are located in high-poverty areas.

Reduce skyrocketing foreclosures. Any new law should preserve the benefits of homeownership by assisting homeowners already in distress. Recent research shows that as many as one out of five subprime mortgages made in recent years will end in foreclosure. In addition to strengthening the market to benefit future borrowers, legislation should address the increasing numbers of existing homeowners who risk losing their home. Federal legislation could build on successful state models to provide affordable homeownership preservation loans to borrowers who are in default due to circumstances beyond their control.

* * * * *

We welcome legislation that, based on the principles outlined above, contains effective solutions to current problems and allows rapid responses to emerging abuses. We look forward to working with you on the critical issue of preserving the benefits of homeownership, and we thank you for your time and consideration.

Sincerely,

AARP
AFL-CIO
American Council on Consumer Awareness
Association of Community Organizations for Reform Now (ACORN)
Center For Responsible Lending
Coalition of Community Development Financial Institutions
Consumer Action
Consumer Federation of America
Consumer Union
International Union, United Auto Workers
Leadership Conference on Civil Rights
NAACP (National Association For The Advancement of Colored People)
NAACP Legal Defense & Educational Fund, Inc.
National Association of Consumer Advocates
National Consumer Law Center (on behalf of its low-income clients)
National Council of La Raza
National Fair Housing Alliance
National Lawyers' Committee for Civil Rights Under Law
National People's Action
National Training and Information Center
Rainbow/ PUSH
U.S. Public Interest Research Group
Affordable Housing Education and Development, Inc. (NH)
Alaska Public Interest Research Group
Alexandria Affordable Housing Corporation (LA)

Allen Neighborhood Center (MI)
American Community Partnerships (DC)
American Friends Service Committee NH Program (NH)
Arizona Consumers Council
Arizona PIRG
Birmingham Business Resource Center (AL)
Border Fair Housing & Economic Justice Center (TX)
Cabrillo Economic Development Corp. (CA)
California Reinvestment Coalition
Cambridge Consumers' Council
CATCH Neighborhood Housing (NH)
Ceiba Housing and Economic Development Corp. (Puerto Rico)
Center for Consumer Affairs (WI)
Center for Social Concerns, University of Notre Dame
Champaign County Health Care Consumers (IL)
Cherokee Nation (OK)
Chicago Consumer Coalition
Cincinnati Change (OH)
Civil Justice, Inc
Coastal Enterprises, Inc. (ME)
Codman Square Neighborhood Development Corp. (MA)
Colorado Rural Housing Development Corporation (CA)
Columbia Consumer Education Council (SC)
Community Development Corporation of Long Island, Inc. (NY)
Community Enterprise Investments, Inc. (FL)
Community Frameworks (WA)
Community Housing Development Corporation of North Richmond
Community Housing Partners Corporation (VA)
Community Law Center
Community Law Center, Inc. (MD)
Community Neighborhood Housing Services, Inc. (MN)
Community Reinvestment Association of North Carolina (NC)
Consumer Federation of California
Consumer Federation of Southeast
Corporation for Enterprise Development (DC)
Cuyahoga County Foreclosure Prevention Program
Dayton Community Reinvestment Coalition (OH)
Delaware Community Reinvestment Action Council, Inc. (DE)
Department of Sociology and Anthropology, IU South Bend
Detroit Alliance for Fair Banking (MI)
Durham Community Land Trustees (NC)
East Akron Neighborhood Development Corporation Inc. (OH)
East Side Organizing Project - Cleveland, OH
Empire Justice Center
Enterprise Corporation of the Delta/HOPE (MS)
Ethical Lending Foundation

Fair Housing Council of the San Fernando Valley Housing Research & Advocacy Center (Cleveland)
Fort Berthold Housing Authority (ND)
Foundation Communities (TX)
Frontier Housing, Inc. (KY)
Greater Rochester Community Reinvestment Coalition (NY)
Hamilton County Community Reinvestment Group (OH)
Hawaiian Community Assets (HI)
HEED (MS)
Hipanic Leadership Coalition of St. Joseph County
Home Management Resources
Homeward, Inc. (IA)
Housing Action Illinois
Housing and Credit Counseling, Inc(KS)
Housing Assistance Program of Essex County, Inc. (NY)
Housing Education Program (CA)
Housing Opportunities Made Equal of Virginia, Inc.
Housing Partnership of Northeast Florida, Inc. (FL)
Indiana Association for Community Economic Development (IN)
Inglewood Neighborhood Housing Services, Inc. (CA)
Interfaith Housing Center of the Northern Suburbs - Chicago, IL
Iowa Citizens for Community Improvement
Jacksonville Area Legal Aid, Inc.
Jewish Community Action (MN)
Joseph Corporation of Illinois, Inc. (IL)
Justine Petersen Housing & Reinvestment Corporation (MO)
Kensington-Bailey Neighborhood Housing Services, Inc. (NY)
Knox Housing Partnership, Inc. (TN)
LaCasa of Goshen, Inc. (IN)
Latino Leadership, Inc. (FL)
Lawyers' Committee For Civil Rights Under Law of the Boston Bar Association (MA)
Lighthouse Community Development - Pontiac, MI
Long Island Housing Services, Inc. (NY)
Louisiana CRA Coalition (LA)
Madison Park Development Corporation (MA)
Manna, Inc. (DC)
Mass Consumers' Coalition
MassPIRG
Metropolitan Housing Coalition (KY)
Metropolitan Milwaukee Fair Housing Council (WI)
Metropolitan St. Louis Equal Housing Opportunity Council (MO)
Miami-Dade Neighborhood Housing Services, Inc. (FL)
Michigan Community Reinvestment Coalition (MI)
Micronesia Self-Help Housing Corporation
Mission Economic Development Agency (MEDA)
Monmouth County Fair Housing Board (NJ)

Montgomery Housing Partnership (MD)
Mountain State Justice, Charleston, WV
National Association of Community Economic Development Associations (MD)
National Community Reinvestment Coalition
National NeighborWorks Association (DC)
Native American Health Coalition (TX)
Navajo Housing Authority (AZ)
Nehemiah Community Reinvestment Fund, Inc. (CA)
Neighborhood Housing Partnership of Greater Springfield, Inc. (OH)
Neighborhood Housing Services of Baltimore, Inc. (MD)
Neighborhood Housing Services of Greater Cleveland, Inc. (OH)
Neighborhood Housing Services of Kansas City, Inc. (MO)
Neighborhood Housing Services of New Haven, Inc. (CT)
Neighborhood Housing Services of Oklahoma City, Inc. (OK)
Neighborhood Housing Services of the Black Hills, Inc. (SD)
Neighborhood Housing Services of the Lehigh Valley, Inc. (PA)
Neighborhood Housing Services, Inc. (PA)
Neighborhood Nonprofit Housing Corporation
Neighborhood Renewal Services of Saginaw, Inc. (MI)
NeighborWorks Columbus (GA)
NeighborWorks Rochester (NY)
New Directions Housing Corporation (KY)
New Jersey Citizen Action (NJ)
NHS of Chicago (IL)
Northeast South Dakota Community Action Program
Northeast South Dakota Economic Corporation
Northwest Indiana Community Reinvestment Alliance (IN)
North West Side Housing Center - Chicago, IL
Norwalk (Connecticut) Fair Housing (CT)
Notre Dame Legal Aid
Nuestra Comunidad Development Corp. (MA)
Opportunity Finance Network
Oregon Consumer League
Piedmont Housing Alliance
Pittsburgh Community Reinvestment Group (PA)
PPEP MicroBusiness and Housing Development Corporation
PPEP Microbusiness and Housing Development Corporation, Inc. (AZ)
Project Change Fair Lending Center (NM)
Reservoir Hill Improvement Council
Resurrection Project - Chicago, IL
Rural Opportunities, Inc. (NY)
Salisbury Neighborhood Housing Services, Inc. (MD)
Sargent Shriver National Center on Poverty Law (IL)
Scott County Housing Council (IA)
Scranton Neighborhood Housing Services, Inc. (PA)
Seedco

Self-Help Enterprises (CA)
Shorebank
Shorebank Enterprise Pacific
Siouxland Economic Development Cooperation
SJF Ventures
South Austin Coalition Community Council - Chicago, IL
South Bend Center for the Homeless
Southeast Community Development Corporation
Southern Good Faith Fund (AR)
Southwest Fair Housing Council (AZ)
St. Joseph Valley Project
St. Lawrence County Housing Council, Inc.
Tlingit-Haida Regional Housing Authority (AK)
Tri-County Housing & Community Development Corporation (CO)
Unidos Para La Gente (TX)
United Keetoowah Band of Cherokee Indians (OK)
United Neighborhood Centers of Northeastern Pennsylvania (PA)
United South Broadway Corporation (NM)
Utica Neighborhood Housing Services, Inc. (NY)
Village Capital Corporation
Virginia Citizens Consumer Council
Virginia Poverty Law Center
West Elmwood Housing Development Corp. (RI)
Westchester Residential Opportunities, Inc. (NY)
Western Massachusetts Enterprise Fund
Wisconsin Consumers League
Working Together for Jobs (NJ)

APPENDIX C

THE OCC'S UNAUTHORIZED PREEMPTION THREATENS CONSUMERS AND FEDERALISM

Issue: For approximately a decade, the Office of the Comptroller of the Currency, a division of the Department of the Treasury, has systematically worked to undermine states' efforts to protect their consumers through measures such as state anti-predatory lending laws. This effort culminated in a cluster of rules issued in 2004 that, in effect, allow the OCC to determine what state law applies to national banks and prohibit state attorneys general or state financial regulators from enforcing any remaining applicable state law.[55] The practical effect of these OCC actions has been to deprive banking customers of basic marketplace protections provided by state law and enforcement actions by state agencies.

The OCC states that its purpose in charting this radical new course is uniformity. In the area of consumer protection, however, Congress has consistently stressed the rights of states to enact greater protections for their citizens. A decision to abolish state consumer protections in the name of banking uniformity should not be made by agency mandate. This is particularly true in the OCC's case because of the inherent conflict between its promotion of federal bank charters (and thus increased OCC funding) and the needs of its banking customers.

A challenge to a 2001 OCC rule that permits operating subsidiaries of national banks to "piggy-back" on the preemption rights of their parents is pending before the Supreme Court in *Watters v. Wachovia Bank, N.A.*, No. 05-1342. While the case may provide judicial guidance on the question of whether the OCC has overreached as to this rule, the remaining rules that preempt state law and states' enforcement rights over national banks are also serious threats to federalism and consumer rights.

Scope of Impact: The OCC supervised banks holding 67% of total assets of all U.S. commercial banks in 2005. These banks have approximately 500 operating subsidiaries that deal directly with consumers and that can claim their parents' preemption under the OCC's rules. Further, the scope of the agency's preemption affects far more than just national banks and their operating subsidiaries, because federal law, and some state laws, gives non-national banks "parity" rights with national banks. These result in a considerable spill-over preemption to other entities not regulated by the OCC.

Concerns:

1) **Charter competition:** Depository institutions get to choose the type of charter under which they operate, and thus get to choose their regulator. They may chose between state and federal charters, and among federal charters. This has led to "charter competition." The

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[55] This displacement of state enforcement authority is contained in the OCC's claim of broad exclusive "visitorial powers," in 12 C.F.R. 7.4000. The validity of that rule is pending in the Second Circuit. *See OCC v. Spitzer*, 396 F. Supp. 2d 383 (S.D.N.Y. 2005), *appeal docketed,* No. 05-5996cv (2d Cir. 2005).

OCC has marketed its broad preemption of state consumer protections to attract depositories to its charter.

2) **Funding:** The OCC is not funded by Congressional appropriations, but by asset-based assessments on its regulated entities. In 2005, 97% of its operations were funded by revenue from assessments. The agency uses a size-based assessment scale, which makes it especially dependent on a few large banks. In one recent year, for instance, the equivalent of 10% of the OCC's budget ($40M) came from one bank alone.

3) **Imbalance of customer and regulated entity interests:**

- Rule-making and interpretation: The agency's interpretations have been consistently result-oriented to allow banks maximum relief from existing law. For example, "interest" is broadly defined to include many fees for purposes of exporting the laws of business-friendly states and ignoring the laws of the customers' states, 12 C.F.R. § 7.4001(a), but narrowly defined if a broad definition would hurt a bank in its home state, 12 C.F.R. § 7.4001(c).

- Interfering with litigation between banks and their customers or state enforcers: The OCC has expended considerable resources over the last decade filing amicus briefs in litigation on the side of banks against their customers and state enforcement agencies. The amicus activity by the OCC has been substantially higher than other federal financial regulators. In one case, the OCC attempted to stop a state attorney general from pursuing claims of telemarketing fraud by a bank mortgage subsidiary.[56] The company's own employees had described the challenged practice as "unethical," a "fraud," and a "scam."

- Inadequate enforcement to replace the displaced state enforcement: In its recent efforts to display state enforcement authority even as to non-preempted state law, the agency realized it "could not replace something with nothing."[57] The OCC therefore found authority that it had never used for 25 years to enforce the FTC's unfair and deceptive practices law. However, the OCC has used this authority very sparingly, and, in some instances, only after state law enforcement action has begun.

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[56] *Minnesota ex rel. Hatch v. Fleet Mortgage Corp.*, 158 F. Supp. 2d 962 & 181 F. Supp. 2d 995 (D. Minn. 2001).
[57] A former Treasury official gave that explanation for the OCC's first use of the FTC UDAP authority at a legal conference in San Francisco in May, 2002. (Practising Law Institute, *Consumer Financial Services Litigation)*

Consumer Federation of America
1620 I Street, N.W., Suite 200 * Washington, DC 20006

TESTIMONY OF

J. ROBERT HUNTER,
DIRECTOR OF INSURANCE,
CONSUMER FEDERATION OF AMERICA

BEFORE

THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES OF
THE COMMITTEE ON FINANCIAL SERVICES
OF THE
UNITED STATES HOUSE OF REPRESENTATIVES

REGARDING

"ADDITIONAL PERSPECTIVES ON THE NEED FOR INSURANCE REGULATORY REFORM"

OCTOBER 30, 2007

Good morning Mr. Chairman and members of the Subcommittee. My name is Bob Hunter and I am the Director of Insurance for the Consumer Federation of America (CFA). Thank you for inviting me here today to discuss the state of the property/casualty insurance industry in America and the quality of insurance regulation. CFA is a non-profit association of 300 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy, and education. I am a former Federal Insurance Administrator under Presidents Ford and Carter and have also served as Texas Insurance Commissioner. I am also an actuary, a Fellow of the Casualty Actuarial Society, and a member of the American Academy of Actuaries.

America's insurance consumers, including small businesses, are vitally interested in high-quality insurance regulation. I am sad to say, however, that the quality of insurance regulation is weak and declining throughout the nation today. Therefore, your hearing is timely. We especially appreciate the fact that the Subcommittee is beginning its review with an overall examination of insurance regulation – why it exists and what are its successes and failures – rather than solely reviewing proposed legislation. In order to determine whether federal legislation is necessary and what its focus should be, it makes sense for the Committee to first conduct a thorough assessment of the current situation. If the "problems" with the present insurance regulation regime are not properly diagnosed, the "solutions" that Congress enacts will be flawed.

In this testimony, I will first discuss why regulation of the insurance industry is necessary, including a review of the key reasons regulation is required and why some current developments make meaningful oversight even more essential. I will then point out that consumers are agnostic on the question of whether regulation should be at the state or federal level but are very concerned about the quality of consumer protections that are in place, wherever the locus of regulation resides in the future. Consumer advocates have been (and are) critical of the current state-based system. However, we are not willing to accept a new regulatory structure that allows insurers to pit state and federal regulators against each other to further drive down standards or that guts consumer protections in the states and establishes one uniform but weak set of national standards. Next I will list a few of the most pressing problems, including claims practices and availability concerns, that insurance consumers are presently facing that require a regulatory response.

I will then provide a brief history of the insurance industry's desire for federal regulation in the early years of this country and the reasons why the industry switched to favoring state regulation in the latter half of the 19th century. The industry is now split on the question of whether state-based regulation should continue. I will point out that the industry has generally shifted its allegiance over the years to support oversight by the level of government that imposes the weakest regulatory regime and the fewest consumer protections. Since this balance shifts over time, some insurers now favor a new system where they can change from state to federal regulation or back again, should a regulator propose rules that they do not like.

Next I will explain why market "competition" alone cannot be relied upon to protect insurance consumers, in spite of insurer attempts to reduce or eliminate consumer protections. I will also touch on the absence of regulatory oversight of policy forms (i.e., coverages) and risk classifications (i.e., how consumers are grouped for the purpose of charging premiums), the hollowing out of coverage offered in insurance policies, unfair discrimination, and the abdication of the insurance system's primary role in loss prevention. Industry deregulation proposals – which euphemistically claim to focus on "modernization" or "uniformity" – will likely increase the already widespread problems of insurance availability and affordability and further erode incentives for loss prevention. Furthermore, industry claims that competition is incompatible with regulation are not borne out by the facts. The experience in states like California demonstrates that appropriate regulation enhances competition, while also ensuring that insurers compete fairly and in a manner that benefits consumers. The maximization of both competitive forces and regulatory oversight in California has resulted in a generous return for these companies and high-quality protection for consumers.[58]

I then set forth the principles for a regulatory system that consumers would favor, showing ways to achieve regulatory uniformity without sacrificing consumer protections.

Finally, I briefly discuss some of the regulatory proposals put forth in recent years by insurers, including the optional federal charter approach and the SMART Act, both of which CFA strongly opposes. We do support legislation that would repeal the McCarran-Ferguson Act's broad antitrust exemption that insurers enjoy, to end the collusive pricing and other market decisions that are legal today. For example, the Senate Judiciary Committee is considering S. 618, which also has broad support from other national consumer organizations.[59]

Why is Regulation of Insurance Necessary?

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

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

Unfair and Deceptive Policies and Practices: Insurance policies, unlike most other consumer products or services, are contracts that promise to make certain payments under very specific conditions at some point in the future. Consumers can easily research the price, quality and features of a television, but it is much more difficult to make a similar evaluation of complex insurance policies and how these policies will be interpreted and serviced at some point in the future. If they did, they would never accept policies with anti-concurrent causation clauses in

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[58] "Why Not the Best? The Most Effective Auto Insurance Regulation in the Nation," Consumer Federation of America, June 6, 2000.

[59] Consumer organizations that support S. 618 include CFA, the Center for Economic Justice, the Center for Insurance Research, the Center for Justice and Democracy, Consumers Union, the Foundation for Taxpayer and Consumer Rights, New Jersey Citizen Action, Public Citizen, and United Policyholders.

them. Because of the complicated nature of insurance policies, consumers rely on the representations of the seller/agent to a far greater extent than for other products. Regulation exists to prevent competition that fosters the sale of unfair and deceptive policies and claims practices.

Unfortunately, states have fared very poorly in protecting consumers from unfair and deceptive practices. Rather than acting to uncover abuses and instigate enforcement actions, states have often only reacted to lawsuits or news stories that brought harmful practices to light. For example, the common perception among regulators that "fly-by-night" insurance companies were primarily responsible for deceptive and misleading practices was shattered in the late 1980s and early 1990s by widespread allegations of such practices among companies with household names like MetLife, John Hancock, and Prudential. MetLife sold plain whole life policies to nurses as "retirement plans," and Prudential unilaterally replaced many customers' whole life policies with policies that didn't offer as much coverage. Though it is true that state regulators eventually took action through coordinated settlements, the allegations were first raised in private litigation; many consumers were defrauded before regulators acted.

The revelations and settlements resulting from investigations by New York Attorney General Eliot Spitzer show that even the most sophisticated consumers of insurance can be duped into paying too much through bid-rigging, steering, undisclosed kickback commissions to brokers and agents, and through other anticompetitive acts. A *New York Times* article on long-term care insurance claims abuses provides another example of serious problems consumers face in the current weak regulatory climate.[60] The appalling behavior of many insurers in the wake of Hurricane Katrina that resulted from the long-standing use of deceptive practices like anti-concurrent causation clauses are also a noteworthy example of the inadequacy of state oversight.

Claims abuses: Consumers pay a lot of money for insurance policies, which are promises for future protection should some unfortunate event occur. If these promises are broken, the consumer can be devastated. Many concerns have been raised about such broken promises in the poor performance of property-casualty insurers in paying legitimate claims in the wake of Hurricane Katrina. Consider this startling blog from the President of the Association of Property/Casualty Claims Professionals, James Greer, which was posted on the web site of the Editor of the National Underwriter:

James W. Greer, CPCU:

Although I live and work in Florida, my home is on the Mississippi Gulf Coast where I have family spread from one side of the state to the other. I spent six months there leading a team of over 100 CAT adjusters and handling the wind claims for the state's carrier of last resort. I personally walked through the carnage, saw the people, and felt the sorrow. I climbed the roofs, measured the slabs, and personally witnessed very visible and clear damage caused by both water AND WIND.

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[60] "Aged, Frail and Denied Care by Their Insurers," *New York Times*, March 26, 2007.

I also observed something else that surprised me, and, after 28 years as a claims professional who has carried "the soul" of a bygone industry in my practices and preachings, I was ashamed of those to whom I had vested a lifetime career: An overwhelming lack of claims adjusters on the Mississippi Gulf Coast. The industry simply did not respond.

The industry appeared as distant to the Miss. Gulf Coast as the federal government was accused of being to New Orleans. *It was as if some small group of high-level financial magnates decided that the only way to save the industry's financial fate from this mega-disaster was to take a total hand's off approach and hide beneath the waves and the flood exclusion.*

While media reps repeatedly quoted, "Each claim is different and will be handled on its own facts and merits," the carriers behaved as one...if there was evidence of water, or you were within a certain geographic boundary, adjusters were largely absent on the coast. (Emphasis added.)

(Actually, State Farm did have one of the largest CAT facilities, located centrally on the coast, but there was little evidence of other carrier presence.)

I personally observed large carriers simply refusing to respond, or even consider arguments of wind involvement...well-rationalized sets of facts, coverage and legal arguments. The silence from industry officials "far from the field" who retained the authority for claim decision-making was deafening.

In an article posted on the Association of Property & Casualty Claims Professionals' Web site shortly after Katrina hit, I described the catastrophe as "Claims Greatest Challenge," and pondered the industry would respond. Now we know.

As a member of an old Aetna family that has been widely dispersed since its demise in the '90's, I remember the day when leaders of that fine company routinely cited, and tried to honor, the social/moral contract the insurance industry had with society. It is clear that, in today's business environment, the soul of the insurance industry is missing, and despite the rhetoric of its PR machine, the industry no longer recognizes such a social/moral obligation.

As a lifetime claims professional, I will never quit writing, teaching and showing those who are interested the way things should be done to serve the best interests of the industry and its customers according to the best practices and behaviors of a bygone claims age. Perhaps someday a change in mindset will once again begin to evolve.

Clearly, for the Mississippi Gulf Coast, the Katrina catastrophe, the animosity and the litigation, it was never really about flood...nor was it about the flood exclusion. It was, and is, about the failure of the insurance industry to keep its promise...a promise that it will respond when loss occurs.

The only thing sold in insurance is peace of mind. The victims of this storm, and certainly those in Mississippi, will never again find peace of mind in insurance. Actions do speak loudest. On the Mississippi Gulf Coast, the insurance industry simply failed to act. In the end, it will pay dearly for that decision, as will all of society.

James W. Greer, CPCU, President, Association of Property & Casualty Claims Professionals[61]

There are also adverse implications for consumers because of the use of claims payment software by insurance companies. Insurers have reduced their payouts and maximized their profits by turning their claims operations into "profit centers" by using computer programs and other techniques designed to routinely underpay policyholder claims. For instance, many insurers are using programs such as "Colossus," sold by Computer Sciences Corporation (CSC.)[62] CSC sales literature touted Colossus as "the most powerful cost savings tool" and also suggested that the program will immediately reduce the size of bodily injury claims by up to 20 percent. As reported in a recent book, "…any insurer who buys a license to use Colossus is able to calibrate the amount of 'savings' it wants Colossus to generate…If Colossus does not generate sufficient 'savings' to meet the insurer's needs or goals, the insurer simply goes back and 'adjusts' the benchmark values until Colossus produces the desired results."[63] In a settlement of a class-action lawsuit, Farmers Insurance Company has agreed to stop using Colossus on uninsured and underinsured motorist claims where a duty of good faith is required and has agreed to pay class members cash benefits.[64] Other lawsuits have been filed against most of America's leading insurers for the use of these computerized claims settlement products.[65]

Programs like Colossus are designed to systematically underpay policyholders without adequately examining the validity of each individual claim. The use of these programs severs the promise of good faith that insurers owe to their policyholders. Any increase in profits that results cannot be considered to be legitimate. Moreover, the introduction of these systems could explain part of the decline in benefits that policyholders have been receiving as a percentage of premiums paid in recent years.

Colossus has been bought by most major insurance companies in response to marketing efforts by CSC promising significant savings. McKinsey & Company has also encouraged several companies to use Colossus.[66] "Before the Allstate launched a project in 1992 (called CCPR – Claims Core Process Redesign), McKinsey named its USAA project 'PACE' [Professionalism and Claims Excellence]. At State Farm, McKinsey named its project 'ACE' [Advanced Claims Excellence]."[67]

61 "Your Own Worst Enemy, Continued," Blog of Sam Friedman, Editor, National Underwriter Magazine, www.property-casualty.com, February 21, 2007. Posted on January 31, 2007 23:06. The blog has other interesting posts on this subject.

62 Other programs are also available that promise similar savings to insurers, such as ISO's "Claims Outcome Advisor." These are bodily injury systems but other systems, such as Exactimate, "help" insurers control claims costs on property claims.

63 "From Good Hands to Boxing Gloves – How Allstate Changed Casualty Insurance in America," Trial Guides, 2006, Berardinelli, Freeman and DeShaw, pages 131, 133, 135.

64 Bad Faith Class Actions, Whitten, Reggie, PowerPoint Presentation, November 9, 2006.

65 Ibid.

66 "…Mc Kinsey & Co. has taught Allstate and other insurance companies how to deliver less and less." Berardinelli, Freeman and DeShaw, page 17.

67 Ibid. Page 57.

When McKinsey introduced Allstate to Colossus, "McKinsey already knew how Colossus worked having proved it in the field at USAA."[68] This quote was footnoted as follows: "See McKinsey at (PowerPoint slide number) 7341: "The Colossus sites have been extremely successful in reducing severities with reductions in the range of 10 percent for Colossus-evaluated claims."[69]

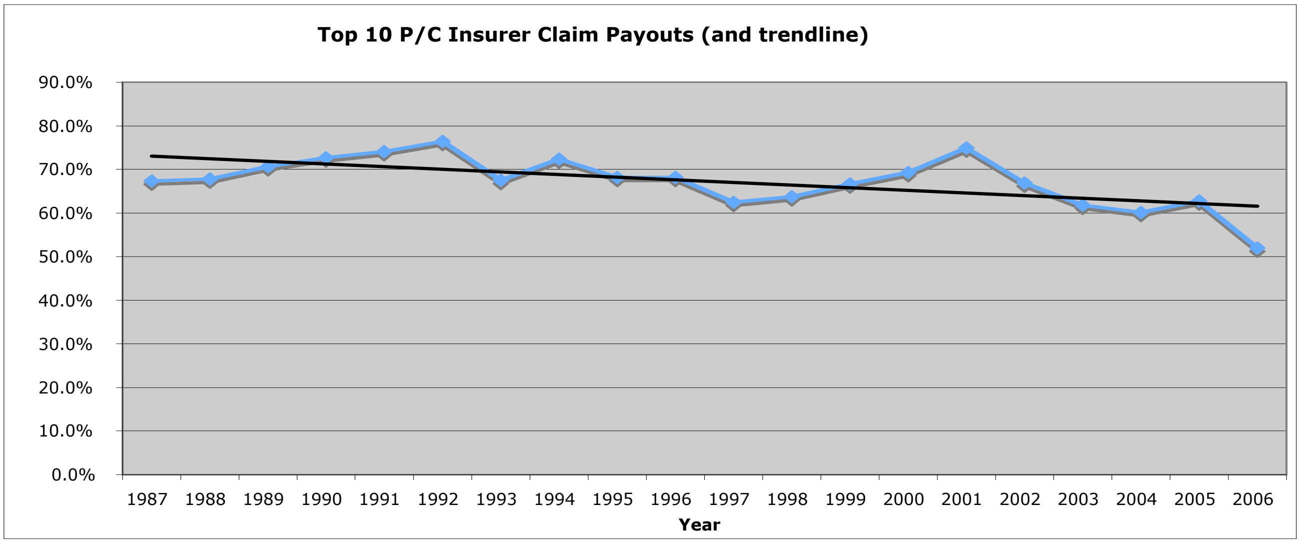
I have been a witness in some of the cases against insurers using the Colossus product and I am covered by a protective order in these cases. (I could go on at length about why these protective orders are bad public policy, particularly coupled with secrecy provisions in settlements, in that the abusive practice that was uncovered often continues to harm people). I am, therefore, limited in this testimony to what is in the public domain. However, as I describe above, there is public information about the use of common consultants and vendors by insurance companies that have adopted Colossus and similar systems. I strongly urge this Committee to probe the question of whether these vendors and consultants have been involved in encouraging and facilitating collusive behavior by insurance companies with these claims systems. I also urge you to investigate whether a similarity in Hurricane Katrina claims payment procedures and actions (or non-actions), as mentioned above, could indicate collusive activity by some insurers.

The use of these products to cut claims payouts may be at least part of the reason that consumers are receiving record low payouts for their premium dollars as insurers reap unprecedented profits. As is obvious in the following graph, the trend in payouts is sharply down over the last twenty years, a period during most state insurance regulators have allowed consumer protections to erode significantly and when Colossus and other claims systems were being introduced by many insurers.[70]

[68] Ibid. Page 132.

[69] Ibid.

[70] CFA tested this drop in benefits related to premiums to see if it could be attributed to a drop in investment income. Over the time frame studied, there was a three percent drop in investment income. Since insurers typically reflect about half of investment income in prices, CFA believes that the drop in investment income accounts for only 1.5 points of the 15-point drop. That is, declining investment income explains only about one-tenth of the drop in benefit payouts to consumers per dollar expended in insurance premium.



It is truly inappropriate for property/casualty insurers to be delivering only half of their premium back to policyholders as benefits.[71]

State insurance departments have been sound asleep on the issue of the negative impact that Colossus and other such products have on policyholder rights, and even on the right to good faith claims settlements. The Federal Trade Commission (FTC) should be empowered to undertake investigations and other consumer protection activities to help stop the insurers from engaging in such acts on a national basis.

Insurance Availability: Some insurance is mandated by law or required by lenders to complete financial transactions, such as mortgage loans. In a normal competitive market, participants compete by attempting to sell to all consumers seeking the product. However, in the insurance market, participants compete by attempting to "select" only the most profitable consumers. This selection competition leads to availability problems and redlining.[72] Regulation exists to limit destructive selection competition that harms consumers and society.

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[71] Insurers contend that the loss adjustment expense is a benefit to consumers. Obviously, this is a "benefit" that is not provided to the consumer or repair cars, doctor bills, etc. But even the loss and LAE ratio itself is at a record low for many decades, at under 70 percent.

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

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

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

Lawsuits brought by fair housing groups and the Department of Housing and Urban Development (HUD) over the past 15 years have revealed that insurance availability problems and unfair discrimination exist and demonstrate a lack of oversight and attention by many of the states. NAIC had ample opportunity after its own studies indicated that these problems existed to move to protect consumers. It retreated, however, when, a few years ago, insurers threatened to cut off funding for its insurance information database, a primary source of NAIC income.

Serious problems with home insurance availability and affordability surfaced this spring along America's coastlines. Hundreds of thousands of people have had their homeowners' insurance policies non-renewed and rates are skyrocketing. As to the decisions to non-renew, on May 9, 2006 the Insurance Services Office (ISO) President and CEO Frank J. Coyne signaled that the market is "overexposed" along the coastline of America. In the *National Underwriter* article, "Exposures Overly Concentrated Along Storm-prone Gulf Coast" (May 15, 2006 Edition), the ISO executive "cautioned that population growth and soaring home values in vulnerable areas are boosting carrier exposures to dangerous levels." He said, "The inescapable conclusion is that the effects of exposure growth far outweigh any effects of global warming."

Insurers started major pullouts on the Gulf Coast in the wake of the ISO pronouncement. On May 12, 2006, Allstate announced it would drop 120,000 home and condominium policies and State Farm announced it would drop 39,000 policies in the wind pool areas and increase rates more than 70 percent.[73] Collusion that would be forbidden by antitrust laws in most other industries appears to be involved in the price increases that have occurred. (See section below entitled "Where Have All the Risk Takers Gone?")

One obvious solution to discrimination and availability problems is to require insurers to disclose information about policies written by geo-code, and about specific underwriting guidelines that are used to determine eligibility and rates. Such disclosure would promote competition and benefit consumers; but state regulators, for the most part, have refused to require such disclosure in the face of adamant opposition from the industry. Regulators apparently agree with insurers that such information is a "trade secret" despite the absence of legal support for such a position. In addition, though insurance companies compete with banks that must meet data disclosure and lending requirements in underserved communities under the Community Reinvestment Act ("CRA"), insurers refuse to acknowledge a similar responsibility to communities.

Reverse Competition: In certain lines of insurance,[74] insurers market their policies to a third party, such as creditors or auto dealers, who, in turn, sell the insurance to consumers on behalf of the insurer for commission and other compensation. This compensation is often not

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

[73] "Insurers Set to Squeeze Even Tighter," *Miami Herald*, May 13, 2006.
[74] Such as credit insurance, title insurance and force-placed insurance.

disclosed to the consumer. Absent regulation, reverse competition leads to higher -- not lower -- prices for consumers because insurers "compete" to offer greater compensation to third party sellers, driving up the price to consumers.

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

The markets for low value life insurance and industrial life insurance are characterized by overpriced and inappropriately sold policies and a lack of competition. This demonstrates the need for standards that ensure substantial policy value and clear disclosure. Insurers rely on consumers' lack of sophistication to sell these overpriced policies. With some exceptions, states have not enacted standards that ensure value or provide timely, accurate disclosure. Consumers continue to pay far too much for very little coverage.[75]

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

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

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

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[75] My April 26, 2006, testimony before the House Committee on Financial Services on title insurance, detailing the reverse competition impact on that vastly overpriced product, can be found at: http://www.consumerfed.org/pdfs/Title_Insurance_Testimony042606.pdf.

The model disclosure law that NAIC eventually adopted is inadequate for consumers trying to understand the structure and actual costs of policies.

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

Are the Reasons for Insurance Regulation Still Valid?

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

- Advances in technology now provide insurers access to extraordinarily detailed data about individual customers and allow them to pursue selection competition to an extent unimaginable ten years ago.
- Insurance is being used by more Americans not just to protect against future risk, but as a tool to finance an increasing share of their future income, e.g., through annuities. We already know that many consumers have been hurt by improper claims practices by some of these insurers.
- Increased competition from other financial sectors (such as banking) for the same customers could serve as an incentive for misleading and deceptive practices and market segmentation, leaving some consumers without access to the best policies and rates. If an insurer can't compete on price with a more efficient competitor, one way to keep prices low is by offering weaker policy benefits (i.e., "competition" in the fine print).
- States and lenders still require the purchase of auto and home insurance. Combining insurer and lender functions under one roof, as allowed by the Gramm Leach Bliley Act, could increase incentives to sell insurance as an add-on to a loan (perhaps under tie-in pressure) – or to inappropriately fund insurance policies through high-cost loans.
- Insurers are gutting coverage provided by homeowners insurance policies in ways that are difficult for consumers to understand or overcome.[76]

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

[76] See the discussion of the anti-concurrent causation clause below.

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

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

I am one of the very few people who have served as both a state and federal insurance regulator.[77] My experience demonstrates that either a federal or state system can succeed or fail in protecting consumers. What is critical is not the locus of regulation, but the quality of the standards and the effectiveness of enforcement of those standards.

Both state and federal systems have potential advantages and disadvantages:

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?	Yes	Yes
Effective guarantee 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 date processing capacity?	Yes	No

Despite many weaknesses that exist in state regulation, a number of states do have high-quality consumer protections. States also have extensive experience regulating insurer safety and soundness and an established system to address and respond to consumer complaints. The burden of proof is on those who for opportunistic reasons now want to shift away from 150 years

[77] I was Texas Insurance Commissioner and Federal Insurance Administrator when the Federal Insurance Administration (FIA) was in HUD and had responsibility for the co-regulation of homeowners insurance in the FAIR Plans, as well as flood and crime insurance duties. The White House had also tasked FIA with keeping abreast of all insurance issues, so we worked on auto insurance issues with DOT, health insurance with HHS, medical malpractice insurance with HHS and DOC, and many other major insurance matters.

of state insurance regulation to show that they are not asking federal regulators and American consumers to accept a dangerous "pig in a poke" that will harm consumers.

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

Top Six Problems Facing Insurance Consumers Today:

1. Insurers Are Increasingly Privatizing Profit, Socializing Risk and Creating Defective Insurance Products by Hollowing out Insurance Coverage and Cherry Picking Locations in Which They Will Underwrite.

There are two basic public policy purposes of insurance. The first is to provide individuals, businesses and communities with a financial security tool to avoid financial ruin in the event of a catastrophic event, whether that event is a traffic accident, a fire or a hurricane. Insurers provide this essential financial security tool by accepting the transfer of risk from individuals and by spreading the individual risks through the pooling of very large numbers of individual risks. The pool of risks is diversified over many types of perils and many geographic locations.

The second essential purpose of insurance is to promote loss prevention. Insurance is the fundamental tool for providing economic incentives for less risky behavior and economic disincentives for more risky behavior. The insurance system is not just about paying claims; it is about reducing the loss of life and property from preventable events. Historically, insurers were at the forefront of loss prevention and loss mitigation.[78] At one point, fire was a major cause of loss. This is no longer true, in large part due to the actions of insurers in the 20th century.

Left to a "competitive" or deregulated market, insurers are undermining these two core purposes of insurance. They have hollowed out the benefits offered in many insurance policies so they no longer represent the essential financial security tool required by consumers and have pushed the risk of loss onto taxpayers through federal or state programs. The most glaring example of these two actions is demonstrated by insurer actions in the wake of Hurricane Katrina. Losses covered by insurance companies were a minority fraction of the losses sustained by consumers because insurers had succeeded in shifting exposure onto the federal government through the flood insurance program,[79] onto states through state catastrophe funds and onto

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[78] Through such innovations as the creation of Underwriter's Laboratory.

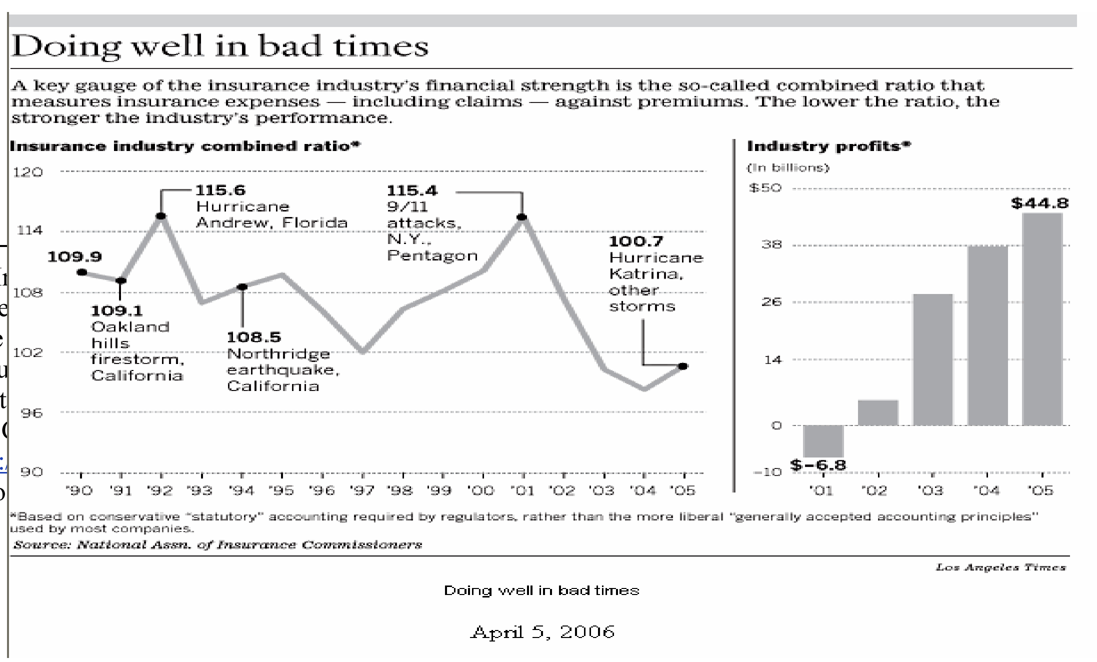
[79] The National flood Insurance Program has been in place since 1968 because insurers could not price or underwrite the risk. Insurers have since developed the technological capacity to create the data necessary for such pricing and underwriting. Consideration should be given by Congress to returning some of this risk to private insurance control. The federal program has had excessive subsidies and has been ineffective in mitigating risk in coastal areas as well as private insurers could.

consumers with higher deductibles and sharply reduced coverage inside of the homeowners insurance policy. Despite the worst catastrophe year ever in terms of dollars paid by the private insurance industry, the property-casualty industry realized record profits in 2005.[80] The trend toward shifting risk away from the primary insurance market has clearly gone too far when the property-casualty insurance industry experiences record profits in the same year as it experiences record catastrophe losses.

The critical conclusion here is that what the insurance industry calls "competition," which is essentially a completely or virtually deregulated market in which price collusion is not prevented by the application of antitrust law, will not protect consumers from unfair or unreasonable classification, policy form or coverage decisions by insurers. The overwhelming evidence is that a market failure regarding policy forms and coverage has triggered a need for greater regulatory oversight of these factors to protect consumers.

Where Have All the Risk Takers Gone? Unaffordable Home Insurance Covers Less and Less Risk

In 2004, four major hurricanes hit Florida, but the property-casualty insurance industry enjoyed record profits of $38.5 billion. In 2005, Hurricane Katrina resulted in the highest hurricane losses ever, but the insurance industry also had another record year of profits, which reached $44.2 billion. Below is a chart from a *Los Angeles Times* article on the subject:[81]



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Since the article was published, the property-casualty industry has reported the largest annual profit in its history in 2006, as cited above.

Insurers often contend that such large returns are justified given the enormous financial risks undertaken by the insurance industry. Although it may be true that reinsurance is a high-risk industry,[82] it is certainly not true for the primary market. In fact, primary insurers have succeeded in eliminating much risk. This is not an opinion, but a simple fact.

If one purchases a property-casualty insurance company's stock, with few exceptions, one has bought into a business that is lower in risk than the market in general, hurricanes notwithstanding. This is shown in any Value Line publication, which tests the risk of a stock. One key measure is the stock's Beta, which is the sensitivity of a stock's returns to the returns on some market index, such as the Standard & Poor's 500. A Beta between 0 and 1, such as utility stocks, is a low-volatility investment. A Beta equal to 1 matches the index. A Beta greater than 1 is anything more volatile than the index, such as a "small cap" fund.

Another measure of a shareholder's risk is the Financial Safety Index, with 1 being the safest investment and 5 being least safe. A third measure of risk is the Stock Price Stability reported in five percentile intervals with 5 marking the least stability and 100 marking the highest.

Consider Allstate. At the same time the company has taken draconian steps to sharply raise premiums and/or reduce coverage for many homeowners in coastal areas, it has presented shareholders with very low risk: Beta = 0.90; Financial Safety = 1, and Stock Price Stability = 95. [83]

ValueLine posts results for 26 property/casualty insurers.[84] The simple averages for these carriers are: Beta = 0.97; Financial Safety = 2.4; and Stock Price Stability = 83.

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82 CFA is still researching this question.

83 ValueLine, December 22, 2006 edition.

84 The stocks are ACE Ltd., Alleghany Corp., Allstate Corp., American Financial Group, W.R. Berkley Corp., Berkshire Hathaway, Inc., CAN Financial, Chubb Corp., Cincinnati Financial, Everest Re Group, HCC Insurance, Hanover Insurance Group, Markel Corp., Mercury General, Ohio Casualty Corp., Old Republic International Corp.,

By all three measures, property/casualty insurance stocks are of below-average risk, safer than buying an S&P 500 index fund. Therefore, long-term below-average returns for insurers should be expected given the low-risk nature of this investment. The low returns demonstrate that the capital market is performing efficiently by awarding below-average returns to a below-average risk industry.

Another measure of how property/casualty insurers have insulated themselves from risk is the extraordinary profits they have earned in recent years. In 2004, insurers posted their largest dollar net (after tax) profit in history ($38.5 billion) despite the fact that four major hurricanes caused significant damage in Florida. Insurers achieved another record of $44.2 billion in 2005, despite the unprecedented losses caused by hurricanes Katrina, Rita, and Wilma. In 2006, profits were the highest ($63.7 billion) yet because of low hurricane activity, excessive rates, the use of programs to systematically keep payments to policyholders low and other reasons discussed in this testimony.

How did insurers do it? Some of the answers are clear:

First, insurers did make intelligent use of reinsurance, securitization, and other risk spreading techniques. That is the good news.

Second, after Hurricane Andrew, insurers modernized ratemaking by using computer models. This development was a mixed blessing for consumers. While this caused huge price increases for consumers, CFA and other consumer leaders supported the change because we saw insurers as genuinely shocked by the scope of losses caused by Hurricane Andrew. Insurers promised that the model, by projecting either 1,000 or 10,000 years of experience, would bring stability to prices. The model contained projections of huge hurricanes (and earthquakes) as well as periods of intense activity and periods of little or no activity.

In the last two years, however, Risk Management Solutions (RMS) and other modelers have moved from using a 10,000-year projection to a five-year projection, which has caused a 40 percent increase in loss projections in Florida and the Gulf Coast, and a 25-30 percent jump in the Mid-Atlantic and Northeast. As a result, the hurricane component of insurance rates has sharply increased, resulting in overall double-digit rate increases along America’s coastline from Maine to Texas. The RMS action interjects politics into a process that should be based solely on sound science. It is truly outrageous that insurers would renege on the promises made in the mid 1990s. CFA has called on regulators in coastal states to reject these rate hikes.

It is clear that insurance companies sought this move to higher rates. RMS’s press release of March 23, 2006 states:

> ‘Coming off back-to-back, extraordinarily active hurricane seasons, the market is looking for leadership. At RMS, we are taking a clear, unambiguous position that our clients should manage their risks in a manner consistent with elevated levels of hurricane

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PMI Group, Inc., Partner Re, Ltd., Progressive Corp., PLI Corp., Safeco Corp., St. Paul/Travelers Group, Selective Insurance, Transatlantic Holdings, 21st Century Insurance Group and XL Group, Ltd.

activity and severity,' stated Hemant Shah, president and CEO of RMS. 'We live in a dynamic world, and there is now a critical mass of data and science that point to this being the prudent course of action.'

The "market" (the insurers) sought leadership (higher rates), so RMS was in a competitive bind. If it did not raise rates, the market would likely go to modelers who did. So RMS acted and other modelers are following suit.[85] It is simply unethical that scientists at these modeling firms, under pressure from insurers, appear to have completely changed their minds at the same time despite having used models for over a decade that they assured the public were scientifically sound. RMS has become the vehicle for collusive pricing.

Almost two years after CFA warned the coastal states and the NAIC about the problems with RMS new methods, little protection for consumers has been put in place. Consumers and businesses in coastal areas have suffered significant harm in the form of unjustified rate increases because the NAIC took no action to end collusion and the retreat from science by the modelers. In fact, the sum total of NAIC's response on an issue that is vital to millions of Americans who live and work near the nation's coastlines was to hold a hearing on whether modeling companies should be regulated. Florida, Georgia, and Louisiana, to their credit, did not allow the new model to be used by primary insurers. New York and Massachusetts have also taken some steps to prevent unjustified rate hikes or policy non-renewals. In the meantime, residents in the other states along the coast have been paying rates up to 50 percent higher solely because of the changes adopted by RMS and other modelers. At the same time, it has become more and more obvious that those who questioned the scientific legitimacy of the modeling changes were correct.

Consider the series of investigative articles on this topic that ran in the *Tampa Tribune* earlier this year indicating that the scientists consulted by RMS on their model no longer support the methodology that was used. "On Saturday, one of the scientists whom Risk Management Solutions consulted, Jim Elsner, a professor of geography at Florida State University, told the Tribune that the company's five-year model 'points to a problem with the way these modeling groups are operating' and that the results contain assumptions that are 'actually unscientific.'… Thomas R. Knutson, a research meteorologist with the National Oceanic and Atmospheric Administration in Princeton, N.J., and another Risk Management expert panelist, said Saturday the five-year timeline didn't come from the experts. 'I think that question was driven more by the needs of the insurance industry as opposed to the science,' he said."[86]

Scientists not employed by RMS are also speaking out: " 'It's ridiculous from a scientific point of view. It just doesn't wash well in the context of the way science is conducted,' said Mark S. Frankel, director of the Scientific Freedom, Responsibility & Law Program at the American Association for the Advancement of Science, in Washington… Charles Watson, an engineer who specializes in numerical hazard models, said RMS acted irresponsibly. 'Especially for something with trillions of dollars in property value, and peoples' lives and livelihood are literally at stake in

[85] According to the *National Underwriter's* Online Service on March 23, 2006, "Two other modeling vendors—Boston-based AIR Worldwide and Oakland, Calif.-based Eqecat—are also in the process of reworking their hurricane models."

[86] New Speaker Challenges Insurance Risk Projections, *Tampa Tribune*, January 10, 2007.

these decisions. It is irresponsible to implement before peer review. There are tremendous policy implications.'"[87]

Even RMS's competitors are stating that the methodology for the 5-year model does not represent good science. In an article in *Contingencies*, the magazine of the American Academy of Actuaries,[88] AIR's Senior Vice President, David A. LaLonde, said, "We [AIR] continue to believe, given the current state of the science, that the standard base model based on over 100 years of historical data and over 20 years of research and development remains the most credible model." AIR's entire premise in the article is that short-term projections, like five years, are not appropriate. Since AIR followed RMS's lead in using the 5-year model despite their misgivings, LaLonde acknowledged that policyholders have experienced rate increases of "as much as 40 % higher than the long-term average in some regions." AIR also seems to confirm the possibility of collusion between modelers and insurers, stating that, "...many in the industry challenged catastrophe models and called for a change."

In a third major development, insurers have not only passed along gigantic price increases to homeowners in coastal areas, but they have also sharply gutted coverage. Hurricane deductibles of two to five percent were introduced. Caps on home replacement costs were also added. State Farm has a 20 percent cap. Other insurers refuse to pay for any increased replacement costs at all, even though demand for home rebuilding usually surges in the wake of a hurricane driving replacement costs up sharply. Insurers also excluded coverage for laws and ordinances, so that if a home has to be elevated to meet flood insurance standards or rewired to meet local building codes, insurers no longer have to pay.

But the most egregious change was the introduction into homeowners' insurance policies of the anti-concurrent causation ("ACC") clause. It removes all coverage for wind damage if another, non-covered event (usually a flood) also occurs, regardless of the timing of the events. Under this anti-consumer measure, if a hurricane of 125-miles-per-hour rips a house apart but hours later a storm surge floods the property, the consumer would receive no reimbursement for wind losses incurred. The use of ACC clauses is intellectually ambiguous, even if the language is found by the courts to be clear.

At a hearing held by the House Financial Services Oversight Subcommittee on February 28th, 2007, Mississippi Attorney General Jim Hood testified that a number of insurance companies operating on the Gulf Coast had tried to escape paying legitimate homeowners' claims after Hurricane Katrina through the use of ACC clauses. Although the ACC clauses were invalidated by a Mississippi judge, insurers intended to refuse to pay wind damage caused by the hurricane if flooding occurred at about the same time, even if the flood hit hours after a home was damaged by wind. The court ruling only affected insurers in Mississippi, so insurers may still be using ACC clauses in other states in the region.

In some cases, particularly those involving the complete destruction of a home down to a slab, insurers did not even seriously study or "adjust" the claim, instead declaring the wind coverage to be trumped by the flood. Such cases often lead to the payment of full flood coverage

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87 Ethicist Questions Insurance Rate Data; *Tampa Tribune*, January 12, 2007.
88 What Happened in 2006? *Contingencies*, March/April 2007.

by the NFIP, even if all or some of the losses paid were really caused by wind damage that should have been paid by insurers under a homeowner's policy.

Consider a $200,000 home that is covered by just a homeowners' policy, with no flood insurance protection. Assume that hurricane winds strike the home for several hours, causing $150,000 worth of damage. Two hours later a flood hits, causing an additional $25,000 in damage for a total damage of $175,000. If the insurer of the home has an ACC, the policyholder would get nothing. If the policyholder had, in addition to the homeowners policy, a flood policy for $200,000, the wind claim would be denied and taxpayers would likely pay $175,000 when they should only pay $25,000. Insurers who get paid handsomely to service the flood insurance program, the Write Your Own ("WYO") companies, should be prohibited from having policy language that has the effect, as ACC does, of shifting insurer losses onto the taxpayers. Congress must make sure that the flood program is not being used by private insurers as a place to lay off their obligations.

Finally, insurers have simply dumped a great deal of risk by not renewing the policies of tens of thousands of homeowner and business properties. Allstate, the leading culprit after Hurricane Andrew, is emerging as the "heavy" once more in the wake of Katrina[89]. After Hurricane Andrew, Allstate threatened to not renew the policies of 300,000 South Floridians, provoking a state moratorium on such action. Today, Allstate is not renewing policies even in places like Long Island and not writing in entire states, like Connecticut. Yes, you heard me right, <u>all</u> of Connecticut, even in places many miles from the coast!

These actions present a serious credibility problem for insurers. They told us, and we believed, that Hurricane Andrew was their "wake up" call because its size and intensity surprised them. This caused them to make massive adjustments in price, coverage, and portfolio of risk. What is their excuse now for engaging in another round of massive and precipitous actions?

Insurers surely knew that forecasters had predicted for decades that an increased period of hurricane activity and intensity would occur from the 1990s to about 2010. They also surely knew a storm of Hurricane Katrina's size, location, and intensity was possible. The *New Orleans Times-Picayune* predicted exactly the sort of damage that occurred in a series of articles more than three years before Katrina hit.[90]

Take Allstate's pullout from part of New York and their refusal to write any new business in the entire state of Connecticut. It is very hard to look at this move as a legitimate step today when no pullout occurred after Hurricane Andrew. Why isn't the probability of a dangerous storm hitting Long Island or Connecticut already accounted for in the modeling – and rate structure – that were instituted after Hurricane Andrew? This type of precipitous action raises the question of whether Allstate is using the threat of hurricane damage as an excuse to drop customers they have had but do not want to retain for other reasons, such as clients in highly congested areas with poorer credit scores. Whether it was mismanagement that started a

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[89] See "The 'Good Hands Company' or a Leader in Anti-Consumer Practices?," Consumer Federation of America, July 18, 2007 at http://www.consumerfed.org/pdfs/Allstate_Report_07_18_07.pdf.
[90] McQuaid, John; Schleifstein, Mark, "Washing Away," *New Orleans Times Picayune.* June 23-27, 2002.

decade ago or the clever use of an opportunity today, consumers are being unjustifiably harmed. Insurance is supposed to bring stability, not turmoil, into peoples' lives.

2. The Revolution in Risk Classification has Created Many Questionable Risk Characteristics, Generated New Forms of Redlining and Undermined the Loss Prevention Role of the Insurance System.

As discussed above, one of the primary purposes of the insurance system is to promote loss prevention. The basic tool for loss prevention is price. By providing discounts for characteristics associated with less risky behavior and surcharges for characteristics associated with more risky behavior, the insurance system provides essential economic signals to consumers about how to lower their insurance costs and reduce the likelihood of events that claim lives or damage property.

Over the past fifteen years, insurers have become more "sophisticated" about rating and risk classification. Through the use of data mining and third party databases, like consumer credit reports, insurers have dramatically increased the number of rating characteristics and rate levels used.

We are certainly not against insurers using sophisticated analytic tools and various databases to identify the causes of accidents and losses. We would applaud these actions if the results were employed to promote loss prevention by helping consumers better understand the behaviors associated with accidents and by providing price signals to encourage consumers to avoid the risky behaviors surfaced by this sophisticated research.

Unfortunately, insurers have generally not used the new risk classification research to promote loss prevention. Rather, insurers have used new risk classifications to undermine the loss prevention role of insurance by placing much greater emphasis on risk factors unrelated to loss prevention and almost wholly related to the economic status of potential policyholders. The industry's new approach to risk classification is a form of redlining, where a host of factors are employed that are proxies for economic status and sometimes race.

For example, although federal oversight of the impact of credit scores in insurance underwriting and rating decisions has been quite poor,[91] it is well-documented in studies by the Texas and Missouri Departments of Insurance that credit scoring has a disproportionately harmful effect on low income and minority consumers.[92] And recently, GEICO's use of data about

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[91] Federal agencies with potential oversight authority paid virtually no attention to the possible disparate impact of the use of credit scoring in insurance until Congress mandated a study on this matter as part of the Fair Access to Credit Transactions (FACT) Act (Section 215). Unfortunately, the agency charged with completing this study, the Federal Trade Commission, has chosen to use data for this analysis from an industry-sponsored study that cannot be independently verified for bias or accuracy, resulting in a study that offers an unreliable and incomplete description of insurance credit scoring and its alternatives.

[92] "Report to the 79th Legislature: Use of Credit Information by Insurers in Texas," Texas Department of Insurance, December 30, 2004; "Insurance-Based Credit Scores: Impact on Minority and Low Income Populations in Missouri," Missouri Department of Insurance, January 2004.

occupation and educational status has garnered the attention of New Jersey legislators.[93] But other factors have not received similar visibility. Several auto insurers use prior liability limits as a major rating factor. This means that for two consumers who are otherwise identical and who are both seeking the same coverage, the consumer who previously had coverage of only the minimum required under law will be charged more than the consumer who previously was able to afford a policy with higher limits. As with credit scoring and occupation/educational status information, this risk classification system clearly penalized lower income consumers.

Once again, deregulated "competition" alone will not protect consumers from unfair risk classification and unfair discrimination. Once again, this market failure demands close regulatory scrutiny of the use of risk classification factors when underwriting, coverage and rating decisions are made.

Let me present one more example of the illegitimate use of risk classification factors to illustrate our concern. Insurers have developed loss history databases – databases in which insurers report claims filed by their policyholders that are then made available to other insurers. Insurers initially used the claims history databases –Comprehensive Loss Underwriting Exchange (CLUE) reports, for example – to verify the loss history reported by consumers when applying for new policies. However, in recent years, insurers started data mining these loss history databases and decided that consumers who merely made an inquiry about their coverage – didn't file a claim, but simply inquired about their coverage – would be treated as if they had made a claim. Penalizing a consumer for making an inquiry on his or her policy is not just glaringly inequitable; it undermines loss prevention by discouraging consumers from interacting with insurers about potentially risky situations.

Although insurers and the purveyors of the claims databases – including ChoicePoint – have largely stopped this practice after much criticism, simple competitive market forces without adequate oversight harmed consumers over a long period and undermined the loss prevention role of the insurance system. Moreover, as with the use of many questionable risk classification factors, competitive forces without regulatory oversight can actually exacerbate problems for consumers as insurers compete in risk selection and price poor people out of markets.

3. Insurance Cartels – Back to the Future

The insurance industry arose from cartel roots. For centuries, property-casualty insurers have used so-called "rating bureaus" to make rates for insurance companies to use jointly. 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 calculating full rates because of lawsuits by state attorneys general. State attorneys general charged in court that the last liability insurance crisis was caused in great part by insurers sharply raising their prices to return to Insurance Services Office (ISO) rate levels in the mid-1980s. As a result of a settlement with these states, ISO agreed to move away from requiring final prices.

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[93] Letter from Consumer Federation of America and NJ CURE to NAIC President Alessandro Iuppa regarding GEICO rating methods and underwriting guidelines, March 14, 2006.

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.[94] 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). Examples of ISO's many anticompetitive activities are attached.

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 data itself would be legal since that would be a pro-competitive 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[95] still have a significant anti-competitive influence on insurance prices in America.

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

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94 A list of activities of ISO is attached as Attachment 3.

95 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) and other non-regulated organizations that impact insurance pricing and other decisions across many insurers (credit scoring organizations like Fair Isaac are one example).

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

More recently, insurers have begun to utilize new third party organizations (like RMS and Fair Isaac) to provide information (often from "black boxes" beyond state insurance department regulatory reach) for key insurance pricing and underwriting decisions, which helps insurers to avoid scrutiny for their actions. These organizations are not regulated by the state insurance departments and have a huge impact on rates and underwriting decisions with no state oversight. Indeed RMS's action, since it is not a regulated entity, may be a violation of current antitrust laws.

The Senate Judiciary Committee is in the midst of a review of the antitrust exemption. The Chairman and bipartisan members of the Committee have introduced S.618, which would repeal the antitrust exemption and provide the FTC with antitrust enforcement authority if insurers engage in anticompetitive behavior not immunized by the state action doctrine. CFA and a number of other national consumer organizations support passage of S.618.[96]

4. Reverse Competition in Some Lines of Insurance

As indicated above, some lines of insurance, such as credit insurance (including mortgage life insurance), title insurance and forced placed insurance, suffer from "reverse competition." Reverse competition occurs when competition acts to drive prices up, not down. This happens when the entity that selects the insurer is not the ultimate consumer but a third party that receives some sort of kickback (in the form of commissions, below–cost services, affiliate income, sham reinsurance, etc.).

An example is credit insurance added to a car loan. The third-party selecting the insurer is the car dealer who is offered commissions for the deal. The dealer will often select the insurer with the biggest kickback, not with the lower rate. This causes the price of the insurance to rise and the consumer to pay higher rates.

Other examples of reverse competition occur in the title and mortgage guaranty lines, where the product is required by a third party and not the consumer paying for the coverage. In these two cases, the insurer markets its product not to the consumer paying for the product, but to the third party who is in the position to steer the ultimate consumer to the insurer. This competition for the referrers of business drives up the cost of insurance – hence, reverse competition.

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[96] My testimony on this bill at the Senate Judiciary Committee hearing of March 7, 2007, can be found at http://judiciary.senate.gov/pdf/03-07-07McCarran-FergusonHearing-HunterTestimony.pdf.

We know from the investigations and settlements by New York Attorney General Eliot Spitzer that even sophisticated buyers can suffer from bid rigging and other negative consequences of "reverse-competition". Even when unsophisticated consumers purchase insurance lines that don't typically have reverse competition, these buyers can suffer similar consequences if they do not shop carefully. Independent agents represent several insurance companies. At times, this can be helpful, but not always. If a buyer is not diligent, an agent could place the consumer into a higher priced insurer with a bigger commission rate for the agent. Unfortunately, this happens too often since regulators have not imposed suitability or lowest cost requirements on the agents.

5. Claims Problems

Many consumers face a variety of claims problems. Often, their only recourse is to retain an attorney, an option that is not affordable for consumers in many situations. For example, many Gulf Coast residents are in litigation over handling of homeowners claims by insurers after Hurricane Katrina. We have seen many reports from consumers of situations that appear to involve bad claims handling practices, particularly related to policy forms that appear ambiguous.[97]

Some insurers have also adopted practices that routinely "low-ball" claims offers through the use of computerized claims processing and other techniques that have sought to cut claims costs arbitrarily.

See the more detailed discussion of claims problems earlier in this testimony.

6. The Revolving Door between Regulators and the Insurance Industry Results in Undue Industry Influence at the National Association of Insurance Commissioners

Consider this list of recent NAIC Presidents and their current place of employment:

2006: Al Iuppa – moved in mid-term as NAIC President to become chief lobbyist for the insurer Zurich Financial Services Group

2005: Diane Koken – recently resigned as Pennsylvania's commissioner to, as an AP story put it: "Koken… said she has accepted a nomination to the board of a national insurance company. She declined to identify the company but said she expects to be elected in April and decided to step down effective Feb. 19 to avoid potential conflicts of interest."[98]

2004: Ernest Csiszar – moved in mid-term as NAIC President to lobby on behalf of the property-casualty insurers as President of the Property Casualty Insurers Association

2003: Mike Pickens – currently lobbies on behalf of insurers as a private attorney

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[97] Reviews of calls to the Americans for Insurance Reform hotline are available at www.insurance-reform.org.
[98] "Diane Koken Resigns After Ten Years as PA Insurance Chief," *The Associated Press*, Feb. 13, 2007. *See* http://www.yorkdispatch.com/pennsylvania/ci_5225171?source=sb-google.

2002: Terrie Vaughn – currently lobbies on behalf of life insurers as a Board Member of Principal Financial Group

2001: Kathleen Sebelius – currently Governor of Kansas

2000: George Nichols – currently works for New York Life

The revolving door of regulators to industry and of industry to regulators is particularly troubling given the role of the NAIC in state insurance regulation.[99] The NAIC plays a major role in guiding state insurance oversight, yet it is organized as a non-profit trade association of regulators and, consequently, lacks the public accountability of a government agency, like an insurance department. For example, it is not subject to Freedom of Information statutes. In addition, policy decisions are made at the NAIC by allowing each state one vote, not matter the population of the state. This means that the Commissioner of Insurance in South Dakota has equal influence as the California or New York regulator. The result is that regulators in states comprising a minority of the country's population can determine national policy for the entire country. This problem is exacerbated by the inappropriate industry influence resulting from the revolving door between regulators and industry.

Why Have Insurers Recently Embraced Federal Regulation (Again)?

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

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

From 1943 until recently, the insurance industry has violently opposed any federal role in insurance regulation. In 1980, insurers successfully lobbied to stop the Federal Trade Commission from investigating deceptive acts and practices of any kind in the insurance industry. They also convinced the White House that year to eliminate the Federal Insurance Administration's work on insurance matters other than flood insurance. Since that time, the

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[99] Studies over they years show that about half of all commissioners come from and return to the insurance industry. Studies also show that about 20 percent of state legislators serving on insurance committees in state legislatures are actively employed directly or indirectly by the insurance industry.

industry has successfully scuttled any attempt to require insurers to comply with federal antitrust laws and has even tried to avoid complying with federal civil rights laws.

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

Further, the insurance industry has used the possibility of an increased federal role to pressure NAIC and the states into gutting consumer protections over the last seven years. Insurers have repeatedly warned states that the only way to preserve their control over insurance regulation is to weaken consumer protections.[100] They have been assisted in this effort by a series of House hearings under the previous Committee leadership. Rather than focusing on the need for improved consumer protection, the hearings served as a platform for a few Representatives to issue ominous statements calling on the states to further deregulate insurance oversight, "or else."

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[100] The clearest attempt to inappropriately pressure the NAIC occurred at their spring 2001 meeting in Nashville, which I witnessed. 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." His remarks were so offensive that I went up to several top commissioners immediately afterward and said that Materra's speech was the most embarrassing thing I had witnessed in 40 years of attending NAIC meetings. I was particularly embarrassed since no commissioner challenged Mattera and many commissioners had almost begged the industry 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 that "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)."

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 already paid off, before the first insurance bill is ever marked up in Congress. In the last few years, the NAIC has moved suddenly to cut consumer protections adopted over a period of decades. The NAIC 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.

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.[101]

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, 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.

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.

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 Jersey, Texas, Louisiana, and New Hampshire have done so in the last three 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.

[101] Florida has held hearings on the practice.

4. NAIC is currently actively considering adoption of personal lines (auto and home insurance) regulatory framework guidance to the states that would severely reduce consumer protections.

Can Competition Alone Guarantee a Fair, Competitive Insurance Market?

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

The need for better regulation that benefits both consumers and insurers is being exploited by some in the insurance industry to eliminate the most effective aspects of state insurance regulation such as rate regulation, in favor of a model based on the premise that competition alone will protect consumers.[102] We question the entire foundation behind the

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[102] 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.

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

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

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

If the industry will not agree to disclose 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.

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 a list of these reasons attached as Attachment 2). The track record of market conduct regulation has been extremely poor. As noted above, insurance regulators rarely are the first to identify major problems in the marketplace.

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

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

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

Is Regulation Incompatible With Competition?

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

The proof that competition and regulation can work together to benefit consumers and the industry is the manner in which California regulates auto insurance under Proposition 103. Indeed, that was the theory of the drafters (including myself) of Proposition 103. Before Proposition 103, Californians had experienced significant price increases under a system of "open competition" of the sort the insurers now seek at the federal level. (No regulation of price is permitted but rate collusion by rating bureaus is allowed, while consumers receive very little help in getting information.) Proposition 103 sought to maximize competition by eliminating the state antitrust exemption, laws that forbade agents to compete, laws that prohibited buying groups from forming, and so on. It also imposed the best system of prior approval of insurance rates and forms in the nation, with very clear rules on how rates would be judged.

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

As of 2005, the average annual premium in California was $844.50 (ranked 18th) vs. $829.17 for the nation.[104] Since California transitioned from relying simply on competition -- as promoted by insurers -- to full competition and regulation, the average auto rate went up by 12.9 percent while the national average rose by 50.2 percent -- a powerhouse result for California's consumers![105] In 1989, California consumers were paying 36 percent more that the national average, while today they pay a mere 2 percent more than the national average price.

How Can Uniformity be Achieved Without Loss of Consumer Protections?

CFA would endorse a more uniform national or multi-state approach if certain rigorous conditions were met. The attached fact sheet, *Consumer Principles and Standards for Insurance Regulation,*[106] provides detailed standards that regulators should meet to properly protect consumers, whether at the state, multi-state or national level. It should be noted that none of recent proposals offered by insurers or on behalf of insurers to Congress come close to meeting these standards.

One obvious vehicle for multi-state enforcement of insurance standards is the NAIC. The NAIC Commission of the Interstate Insurance Product Regulation Compact began operation with a small staff on June 13th of this year. We have favored empowering the NAIC to implement such a multi-state approach only if the NAIC's decision-making procedures are overhauled to make it a more transparent, accountable body with meaningful regulatory powers. These steps would include public access to insurer filings during the review process and formal, funded consumer participation. To date, regulators have refused to take these steps. Moreover, the Commission will be unlikely to carry out its role as a truly independent regulator due to

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[103] "Why Not the Best? The Most Effective Auto Insurance Regulation in the Nation," Consumer Federation of America, June 6, 2000.
[104] State Average Expenditures & Premiums for Personal Automobile Insurance in 2001, NAIC, July 2005.
[105] Insurers have posted excellent profits as well. Over the decade ending in 2004, California insurers enjoyed a return on equity for private passenger auto insurance of 11.1 percent vs. 8.5 percent for the nation (Report on Profitability by Line by State 2004, NAIC).
[106] See Attachment 1.

inadequate funding. The Commission will be receiving and reviewing life, annuity and long term care filings for at least 27 states, but its current budget only allows for a total staff of three people. As stated above, recent NAIC failures demonstrate that it is not an impartial regulatory body that can be counted on to adequately consider consumer needs.

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

- 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 bill should establish a system of state funding to the NAIC at a set percentage of premium so that all states and insured entities equally fund the NAIC.
- National Independent Advocate. To offset industry domination, an independent, national, public insurance counsel/ombudsman with necessary funding is needed. Consumers must be adequately represented in the process for the process to be accountable and credible.

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

When I was Texas Insurance Commissioner, I had to go into another state to seek a court order to declare an insurer, domiciled in the other state, insolvent. The commissioner of that state refused to do so because of local politics (several ex-governors were on the Board of the failed insurer).

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

- It promotes forum shopping. Companies would move from state to state to secure regulation from the state that has the least capacity to regulate, provoking a "race to the bottom."
- The state of domicile is often under the greatest political and economic pressure not to act to end harmful business practices by a powerful in-state company.
- The resources of states to properly regulate insurance vary widely.
- It is antithetical to states' rights to apply laws from other states to any business operating within their borders. If such a move is made, however, it is imperative that consumers have a national, independent advocate.

- It promotes a lack of consistency in regulation because companies could change domiciliary state status.
- Residents of one state cannot be adequately represented by the legislature/executive of another. If a resident's state consumer protections did not apply, the resident would be subject to laws of a state in which they have no representation. How can a consumer living in Colorado influence decisions made in Connecticut?
- Rather than focusing on protecting consumers, this system would change the focus to protecting itself and its regulatory turf, as has happened in the bank regulatory system. State and federal banking regulators have competed to lower their consumer protections to lure banks to their system.
- We would be particularly concerned with proposals to give exclusive control of market conduct exams to a domiciliary state. Unscheduled exams by a state are very important for that state's ability to protect its consumers from abuse. States must retain the ability to act quickly based on complaints or other information.

"One-Stop" Policy Approval Must Meet High Standards

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

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

- To retain oversight of policies and rates affecting their residents, states must have the ability to reject decisions of the entity.
- Any national system must include a national, externally funded consumer-public advocate/counsel to represent consumers in standard setting, development of forms, rate approval, etc.

Recent Federal Proposals

Given the extremely sorry state of state regulation, it is hard to believe that a federal bill could be crafted that would make matters worse. Yet, insurers have managed to do it – not once, but twice! Their bills not only do not provide the basic standards of consumer protection cited above, they would undermine the extremely low standards of consumer protection now extant in many states.

Greater resistance in Congress and extremely low public opinion of insurers in the wake of their poor performance after Hurricane Katrina, which occurred as the insurers rolled to three years of record profits in a row, has led insurers to temporarily step back from regulatory "reform." As one insurance lobbyist told me, "We are not pushing in this atmosphere – we do not want to risk having a bill that actually might enhance regulation, our goal all along has been deregulation, not uniformity." Nonetheless, it is important to reflect on how harmful to consumers these proposals would be.

Insurer Dream Bill #1: Optional Federal Insurance Charter

The bills that have been drafted by trade associations like the American Bankers Association and the American Council of Life Insurers would create a federal regulator that would have little, if any, authority to regulate price or product, regardless of how non-competitive the market for a particular line of insurance might be. (This bill has been introduced in the House as H.R. 3200 by Representatives Bean and Royce and in the Senate as S. 40 by Senators Johnson and Sununu.) The bills also offer little improvement in consumer protection or information systems to address the major problems cited above. Insurers would be able to choose whether to be regulated by this weak federal regulator or by state regulators.

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 that does not allow insurers to run back to the states when regulation gets tougher than they want. We could all debate the merits of that approach. CFA and the entire consumer community stand ready to fight optional charters with all the strength we can muster.

Insurer Dream Bill #2: 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 override important state consumer protection laws, sanction anticompetitive practices by insurance companies and incite state regulators into a competition to further weaken insurance oversight. It is quite simply one of the most grievously flawed and one-sided pieces of legislation that we have ever seen, with absolutely no protections 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 have preempted state regulation of insurance rates. Imagine the impact on the Gulf Coast of that "brilliant" idea! This would leave millions of consumers vulnerable to price gouging, as well as abusive and discriminatory insurance classification practices. It would also encourage a return to insurance redlining, as deregulation of prices would include the lifting of state controls on territorial line drawing. States would be helpless to stop the misuse of risk classification information, such as credit scores, territorial data, and the details of consumers' prior insurance history, for pricing purposes. The draft 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.

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

CFA supports the goals outlined in several sections of this draft. As stated above, we are not opposed to increasing uniformity in insurance regulation. Unfortunately, however, in almost every circumstance in which the draft attempts to ensure uniformity, it chooses the weakest consumer protection approach possible. Like the OFC, this approach has no chance in the current Congress, given the outrage over insurer practices and profits.

Insurer Dream #3: Non-admitted Insurance/Reinsurance Regulation

This bill, which was initially only one of 17 titles in the SMART Act, preempts states only in the regulation of surplus lines of insurance and reinsurance. This legislation (H.R. 1065) has passed the House of Representatives this year and has been introduced this year by Senators

Martinez and Nelson as S. 929. 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 (Section 107(3)) 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. Moreover, 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.

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. (Section 103 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 is 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 (Section 102). 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 (Section 105) 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 guarantee association protection.

Similarly, the bill (Section 202(a)) 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. As stated above, when I was Insurance Commissioner of Texas, I had to investigate an insolvent insurer in another state because the commissioner of that state refused to do so.

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, Section 103 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 Bill: The Insurance Consumer Protection Act of 2003

Only one recent bill considers the consumer perspective in its design, adopting many of the consumer protection standards cited in this testimony. That was S. 1373 of 2003 introduced by Senator Hollings. The bill would adopt a unitary federal regulatory system under which all interstate insurers would be regulated. Intrastate insurers would continue to be regulated by the states.

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

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

<u>A Pro-Consumer Bill Whose Time has Come: Amending the McCarran- Ferguson Act to Remove the Antitrust Exemption</u>

Insurers say they want competition alone to determine rates. The best way for Congress to help spur competition in the insurance industry would be to repeal the McCarran Ferguson

Act, as proposed by S. 618. This would test the industry's desire to compete under the same rules as virtually all other American businesses.

Wisely, S. 618 also unleashes the Federal Trade Commission to perform oversight of anticompetitive insurer behavior, a key step necessary for effective and efficient consumer protection. We strongly support passage of this legislation.

<u>Another Pro-Consumer Bill: Improving Disclosure to Consumers</u>

One cause of the problems we have witnessed in the settlement of Hurricane Katrina claims is that consumers cannot understand complex insurance policy language. Senator Lott's Bill, S.1061, the "Homeowner's Insurance Noncoverage Disclosure Act," is an essential step to help people know what will not be covered if some calamity occurs to a home. The use of the FTC, an agency too long restrained from helping Americans with insurance problems, is also welcome. CFA supports passage of S.1061.

Conclusion

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

ATTACHMENT 1

Consumer Principles and Standards for Insurance Regulation

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.

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.

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

- Where coverage is mandated by the state or required as part of another transaction/purchase by the private market (e.g., mortgage), regulatory intervention is appropriate to assure reasonable affordability and guarantee availability.
- Market reforms in the area of health insurance should include guaranteed issue and community rating and, where needed, subsidies to assure health care is affordable for all.
- Information sufficient to allow public determination of unfair discrimination must be available. For example, geo-code data, rating classifications, and underwriting guidelines 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.

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.

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).

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.

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 a 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.

Consumers should be adequately represented in the regulatory process.

- Consumers should have representation before regulatory entities that are independent, external to regulatory structure, and are 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 important to ensure that the needs of certain populations in the state and the needs of changing technologies are met.

ATTACHMENT 2

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

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

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

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

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

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

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

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

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

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

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

Compare shopping for insurance with shopping for a can of peas. When you shop for peas, you see the product and the unit price. All the choices are before you on the same shelf. At the checkout counter, no one asks where you live and then denies you the right to make a purchase. You can taste the quality as soon as you get home and it does not 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.

ATTACHMENT 3

COLLUSIVE ACTIVITY BY THE INSURANCE SERVICES ORGANIZATION THAT IS ALLOWED BY THE MCCARRAN-FERGUSON ANTITRUST EXEMPTION

The ISO website has extensive information on the range of services they offer insurance companies. The website illustrates the deep involvement that this organization has in helping to set insurer rates, establishing policy forms, underwriting policies, and in setting other rules.

Some examples:

- The page "The State Filing Handbook," promises 24/7 access to "procedures for adopting or modifying ISO's filings as the basis for your own rates, rules and forms."

- The page "ISO MarketWatch Cube" is a "powerful new tool for analyzing renewal price changes in the major commercial lines of insurance…the only source of insurance premium-change information based on a large number of actual policies." This price information is available "in various levels of detail – major coverage, state, county and class groupings – for specific time periods, either month or quarter…"

- "MarketWatch" supplies reports "that measure the change in voluntary-market premiums (adjusted for exposure changes) for policies renewed by the same insurer group…a valuable tool for…strategically planning business expansion, supporting your underwriting and actuarial functions…"

- "ISO's Actuarial Service" gives an insurer "timely, accurate information on such topics as loss and premium trend, risk classifications, loss development, increased limits factors, catastrophe and excess loss, and expenses." Explaining trend, ISO points out that the insurer can "estimate future costs using ISO's analyses of how inflation and other factors affect cost levels and whether claim frequency is rising or falling." Explaining "expenses" ISO lets an insurer "compare your underwriting expenses against aggregate results to gauge your productivity and efficiency relative to the average…" NOTE: These items, predicting the future for cost movement and supplying data on expenses sufficient for turning ISO's loss cost filings into final rates, are particularly anti-competitive and likely, absent McCarran-Ferguson antitrust exemption protection, illegal.

- "ISO's Actuarial Services" web page goes on to state that insurers using these services will get minutes and agendas of "ISO's line actuarial panels to help you keep abreast of ratemaking research and product development."

- The "Guide to ISO Products and Services" is a long list of ways ISO can assist insurers with rating, underwriting, policy forms, manuals, rate quotes, statistics, actuarial help, loss reserves, policy writing, catastrophe pricing, information on specific locations for property insurance pricing, claims handling, information on homeowner claims, credit scoring, making filings for rates, rules and policy forms with the states and other services.

Finally, ISO has a page describing "Advisory Prospective Loss Costs," which lays out the massive manipulations ISO makes to the historic data. A lengthy excerpt follows:

"Advisory Prospective Loss Costs are accurate projections of average future claim costs and loss-adjustment expenses — overall and by coverage, class, territory, and other categories.
Your company can use ISO's estimates of future loss costs in making independent decisions about the prices you charge for your policies. For most property/casualty insurers, in most lines of business, ISO loss costs are an essential piece of information. You can consider our loss data — together with other information and your own judgment — in determining your competitive pricing strategies.

"**The insurance pricing problem** –Unlike companies in other industries, you as a property/casualty insurer don't know the ultimate cost of the product you sell — the insurance policy — at the time of sale. At that time, losses under the policy have not yet occurred. It may take months or years after the policy expires before you learn about, settle, and pay all the claims. Firms in other industries can base their prices largely on known or controllable costs. For example, manufacturing companies know at the time of sale how much they have spent on labor, raw materials, equipment, transportation, and other goods and services. But your company has to *predict* the major part of your costs — losses and related expenses — based on historical data gathered from policies written in the past and from claims paid or incurred on those policies. As in all forms of statistical analysis, a large and consistent sample allows more accurate predictions than a smaller sample. That's where ISO comes in. The ISO database of insurance premium and loss data is the world's largest collection of that information. And ISO quality checks the data to make sure it's valid, reliable, and accurate. But before we can use the data for estimating future loss costs, ISO must make a number of adjustments, including loss development, loss-adjustment expenses, and trend.

"Loss development …because it takes time to learn about, settle, and pay claims, the most recent data is always incomplete. Therefore, ISO uses a process called *loss development* to adjust insurers' early estimates of losses to their ultimate level. We look at historical patterns of the changes in loss estimates from an early evaluation date — shortly after the end of a given policy or accident year — to the time, several or many years later, when the insurers have settled and paid all the losses. ISO calculates *loss development factors* that allow us to adjust the data from a number of recent policy or accident years to the ultimate settlement level. We use the adjusted — or developed — data as the basis for the rest of our calculations.

"Loss-adjustment expenses – In addition to paying claims, your company must also pay a variety of expenses related to settling the claims. Those include legal-defense costs, the cost of operating a claims department, and others. Your company allocates some of those costs — mainly legal defense — to particular claims. Other costs appear as overhead. ISO collects data on allocated and unallocated loss-adjustment expenses, and we adjust the claim costs to reflect those expenses.

"Trend –Losses adjusted by loss-development factors and loaded to include loss-adjustment expenses give the best estimates of the costs insurers will ultimately pay for past policies. But you need estimates of losses in the future — when your new policies will be in effect. To produce those estimates, ISO looks separately at two components of the loss cost — claim *frequency* and claim *severity*. We examine recent historical patterns in the number of claims per unit of exposure (the frequency) and in the average cost per claim (the severity). We also consider changes in external conditions. For example, for auto insurance, we look at changes in speed limits, road conditions, traffic density, gasoline prices, the extent of driver education, and patterns of drunk driving. For just three lines of insurance — commercial auto, personal auto, and homeowners — ISO performs 3,000 separate reviews per year to estimate loss trends. Through this kind of analysis, we develop *trend factors* that we use to adjust the developed losses and loss-adjustment expenses to the future period for which you need cost information.

"What you get – With ISO's advisory prospective loss costs, you get solid data that you can use in determining your prices by coverage, state, territory, class, policy limit, deductible, and many other categories. You get estimates based on the largest, most credible set of insurance statistics in the world. And you get the benefit of ISO's renowned team of actuaries and other insurance professionals. ISO has a staff of more than 200 actuarial personnel — including about 50 members of the Casualty Actuarial Society. And no organization anywhere has more experience and expertise in collecting and managing data and estimating future losses."

ISO's activities extensively interfere with the competitive market, a situation allowed by the provisions of the McCarran-Ferguson Act's extensive antitrust exemption.