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<u>Oral Testimony</u>

State insurance regulation consists predominantly of relatively strict rules, such as capital requirements and underwriting restrictions. Such rules are often appropriate mechanisms to regulate as complex an industry as insurance. Unfortunately, in their focus on command and control regulation, state insurance regulators have historically ignored an equally vital, and much less intrusive, regulatory strategy: promoting transparency in consumer-oriented property/casualty and life insurance markets.

Currently, most states do a remarkably poor job of promoting transparent insurance markets. This failing occurs at two levels. First, most states do not empower consumers to make informed decisions among competing carriers. For instance, in personal lines markets – such as home, auto, and renters insurance – consumers have no capacity to identify or evaluate the substantial differences in carriers' insurance policies. Consumers cannot acquire policies before, or even during, purchase; instead, they receive them only weeks after the fact. Meanwhile, no disclosures warn consumers to consider differences in coverage, much less enable them to evaluate these differences. Similar deficiencies prevent consumers from comparing carriers' claims-paying practices. Consumers neither receive nor can access reliable measures of how often or how quickly carriers pay claims. Finally, consumers are almost never informed that ostensibly independent agents typically have financial incentives to steer them to particular carriers who may not provide optimal coverage. Given this collective lack of transparency, it is hardly surprising that several large national companies have started to hollow out their coverage and embrace aggressive claims handling strategies.

The failure of state regulators to provide consumers with sufficient information extends to life insurance markets as well. Perhaps the most notable example is that consumers have virtually no means of comparing prices or costs for the cash value life insurance products that different companies offer. When combined with skewed (and non-disclosed) salesperson incentives, this too has produced distressing results. For instance, a substantial majority of life insurance sold in this country is cash value, even though less expensive (and, for insurers, less profitable) term coverage is a better option for the vast majority of individuals.

The second broad transparency failing of state insurance regulators involves the absence of publicly available market information. Unlike the consumer disclosures discussed above – which must be simple, focused, and properly timed – this second form of transparency involves making detailed market information broadly available, typically through the Internet. Most consumers, of course, are unlikely to consult such information. But this form of transparency is nonetheless crucial for markets to operate effectively because it allows market intermediaries – including consumer-oriented magazines, public interest groups, and academics – to police marketplaces, identify problems, and convey relevant information to consumers, newspapers, and lawmakers.

Currently, insurance regulation does a dismal job of making publicly available the information that market intermediaries need to perform this watchdog role. For instance, carriers' terms of coverage are not generally publicly accessible – insurers do not post their policies online and most insurance regulators do not maintain up to date or accessible records on the policies that different companies employ. Company-specific market conduct information – including data on how often claims are paid within specified time periods, how often claims are denied, how often policies are non-renewed after a claim is filed, and how often policyholders sue for coverage – is also hidden from public scrutiny and treated as confidential. Virtually no states make available geo-coded, insurer-specific application, premium, exposure, and claims data, similar to that required of lenders by the Home Mortgage Disclosure Act. Product filings with the states and the Interstate Insurance Product Regulation Commission (IIPRC) are not made public before approval, thus precluding public comment. And even companies' annual financial statements are only accessible on the Internet for a fee, in notable contrast to the public availability of companies' SEC filings.[1]

[1] Individuals can download five free reports a year if they agree not to use them for commercial purposes.

To be sure, the National Association of Insurance Commissioners (NAIC) has started to address some of these issues. But the results to date have ranged from preliminary to inadequate. Its model annuity and life disclosure regulations, for instance, rely on generic buyers' guides and broad standards for insurer disclosure without affirmatively developing tools that consumers need to make cross-company comparisons, such as the mortgage disclosure forms that the Consumer Financial Protection Bureau has developed in recent months. Work in the personal lines context has only recently started after years of consumer pressure. And in many domains, the NAIC has affirmatively rejected transparency. Examples include its refusal to make publicly available data on carriers' market conduct or on the availability and affordability of property insurance in specific geographic areas.

In sum, state insurance regulation has generally failed at a core task of consumer protection regulation – making complex markets comprehensible to consumers and broadly transparent to those who may act on their behalf. This type of transparency is fundamental to fostering competitive and efficient markets. Historically, state insurance regulators have responded promptly to federal pressure: in the face of such scrutiny, they shored up solvency regulation, coordinated agent licensing, and streamlined product review. The federal government should apply similar pressure on state regulators to develop a robust and thoughtful transparency regime. Specifically, Congress should press the new Federal Insurance Office to work with consumer groups to assess transparency in consumer insurance markets. That Office should compare this state of affairs with the transparency standards under development at the federal level in the context of consumer credit and health insurance. The sharp contrasts that are revealed will hopefully either prompt states to correct these problems or precipitate federal regulation doing so.

More Detailed Information on Failed Transparency in Insurance Markets

In evaluating the lack of transparency in insurance markets described above, consider first the core product that insurers sell: insurance policies. Unlike virtually any other market, it is virtually impossible for purchasers of personal lines coverage – including homeowners, renters, and auto insurance – to scrutinize this product before they purchase it.[2] Insurers only provide consumers with an actual insurance contract several weeks after they purchase coverage. They do not make sample contracts available to consumers on the Internet or through insurance agents. Marketing materials and other secondary literature from regulators and consumer organizations provide virtually no guidance about how different carriers' policies differ. And most states have essentially zero laws requiring insurers to provide any types of pre-sale disclosure to consumers regarding the scope of their coverage.

This distressing lack of transparency can be traced back to the assumption of regulators that personal lines policies are completely uniform, meaning that disclosure just does not make sense. Historically this assumption was premised on laws that required complete uniformity: most states, for instance, mandated the use

[2] This analysis is based on my forthcoming article, *Reevaluating Standardized Insurance Policies*, 77 UNIVERSITY OF CHICAGO LAW REVIEW (forthcoming 2011), *available at* http://ssrn.com/abstract=1687909.

of state promulgated fire insurance policies. But these rules gradually faded, in large part because insurers voluntarily adopted uniform policies in new insurance lines, such as homeowners. As often happens, though, market conditions changed. Today, homeowners insurance policies, and likely other personal lines insurance policies, often differ radically with respect to numerous important coverage provisions. In fact, some of the largest insurers in America have substantially degraded the scope of the coverage they provide in their policies. Yet state insurance regulation currently does nothing to provide consumers with the information they need to identify these companies and make their market decisions accordingly.

A second arena in which state insurance regulation fails to promote market transparency involves information on the claims-paying records of carriers.[3] Most states collect extensive market conduct data in various lines of insurance, including private passenger auto, residential property, and life and annuities. These data measure, on a company-specific basis, crucial issues that reflect companies' claims-paying practices, such as such as how often claims are paid within specified time periods, how often claims are denied, how often policies are non-renewed after a claim is filed, how often consumers complain to the company directly, and how often policyholders sue for coverage.

Although obviously central to evaluating the quality of different insurance products, regulators do not systematically make this information available to the

[3] I have also discussed this issue in my previous work, including *Regulating Insurance Sales or Selling Insurance Regulation? Against Regulatory Competition in Insurance*, 94 MINNESOTA LAW REVIEW 1707, 1761 (2010), available at http://ssrn.com/abstract=1503127.

public.[4] Instead, regulators treat it as confidential. In many cases, this claim is legally dubious: at least some of this information occasionally appears in publicly available market conduct exams for specific companies. But the larger issue is why insurance regulators have not worked to alter state laws to the extent that they require this confidentiality, given the importance of this information to assessing the quality of coverage that different carriers provide. In almost all cases, the claim that these data are proprietary is facially implausible: the data reveal how well different companies fulfill their obligations, information which in no sense is the result of insurers' investments in knowledge production.

Yet a third arena in which state insurance regulation fails to promote transparency involves the availability and cost of property/casualty insurance in low-income or minority residential communities.[5] Such insurance is a pre-requisite to a wide range of activities, from starting a business to purchasing a home. Moreover, it has long been recognized that certain pricing and marketing practices may disproportionately impact low-income communities. Even if these practices do not involve discriminatory intent, they may constitute a violation of the Fair Housing Act if they have a disparate impact on protected groups and a less discriminatory alternative is available. In response to these concerns, federal law,

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[4] The only insurer-specific market-conduct information that regulators do provide to consumers is information about how often consumers complain to insurance departments about their carriers. Although this data is valuable, it is hardly a substitute for the more specific market conduct data described above. Most importantly, only a small and unrepresentative subset of consumers ever complain to state insurance departments. Additionally, consumer complaints concern myriad issues that are disaggregated only in very imprecise ways.

[5] *See generally* Gregory D. Squires, *Racial Profiling, Insurance Style: Insurance Redlining and the Uneven Development of Metropolitan Areas*, 25 JOURNAL OF URBAN AFFAIRS 391 (2003); Gregory D. Squires & Charis E. Kubrin, *Privileged Places: Race, Uneven Development and the Geography of Opportunity in Urban America*, 42 URBAN STUDIES 47 (2005).

through the Home Mortgage Disclosure Act (HMDA), has long required lenders to provide the public with robust information on the availability of home loans. HMDA requires lenders to report and make publicly available geo-coded information regarding home loans, loan applications, interest rates, and the race, gender, and income of loan applicants. This information has promoted richer understanding of credit availability and discrimination, helped identify discriminatory lending practices, and prompted various initiatives to make credit more available in traditionally under-served areas.

By contrast, the vast majority of insurance regulators have repeatedly refused to provide the public with any HMDA-like data regarding the availability of homeowners insurance. One survey found that only four states make insurer-specific, geo-coded data publicly available for homeowners insurance, and no state makes publicly available loss or pricing data for individual insurers. Most state regulators have repeatedly ignored requests to devise a model law that would require such data collection and dissemination. This is particularly troubling because the evidence that is available suggests that homeowners insurance is systematically more expensive and less available in certain low-income, urban areas. Thankfully, the Dodd-Frank Act specifically authorizes the Federal Insurance Office to collect and publish this data.[6]

Insurance regulators have also generally refused to promote transparency with respect to the compensation and incentives of ostensibly independent

[6] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, Sec. 502(a) (2010).

insurance agents.[7] Insurance agents frequently receive different amounts of compensation for placing consumers with different carriers. Often this is a result of "contingent commissions," which are essentially year-end bonuses to agents based on the volume and/or profitability of the business sent to the insurer. Alternatively, some carriers may simply pay higher upfront "premium" commissions. Either way, differential compensation of agents creates obvious incentives for agents to place customers with particular carriers who may not always be optimal for the individual consumer.

Despite this, the vast majority of states do not require independent agents to disclose this potential conflict of interest to their customers, nor do they limit the capacity of these agents to promote their "independence" to consumers. Most states do not currently have any regulations regarding the disclosure of agent compensation. Those that do typically do not require any such disclosure unless the agent received compensation from the customer, which is highly atypical in most consumer transactions. Only a single state, New York, requires that agents disclose prior to sale that "the compensation paid to the insurance producer may vary depending on a number of factors, including (if applicable) the insurance contract and the insurer that the purchaser selects, the volume of business the producer

[7] To be sure, I have argued before and continue to believe that the regulatory problems created by contingent commissions are particularly resistant to disclosure-based responses. *See* Daniel Schwarcz, *Differential Compensation and the Race to the Bottom in Consumer Insurance Markets*, 15 Connecticut Insurance Law Journal 723 (2009), *available at* http://ssrn.com/abstract=1333291; Daniel Schwarcz, *Beyond Disclosure: The Case for Banning Contingent Commissions*, 25 Yale Law & Policy Review 289 (2007), *available at* http://ssrn.com/abstract=953061. At the same time, though, effective disclosure-based responses in this domain are clearly better than the status quo, wherein ostensibly independent insurance agents market themselves to consumers as trusted, independent advisors while operating under strong incentives to steer customers to particular carriers.

provides to the insurer or the profitability of the insurance contracts that the producer provides to the insurer."[8]

In the life insurance arena, the NAIC has seemingly devoted more attention to promoting transparency, as it has developed Life Insurance and Annuities Disclosure Model Regulations in recent years. Both rules require consumers to be provided with a generic buyers' guide and establish basic standards for the provision of additional information by companies. Although better than nothing, these rules do little to affirmatively empower consumers to choose among the immensely complex products being offered by different companies. To achieve this, regulators must design specific, consumer-tested, required disclosures that combine essential product information into a few basic indices and/or measures. Good examples of such disclosures include the mortgage disclosure forms that the Consumer Financial Protection Bureau recently unveiled as well as the health insurance disclosure form that Health & Human Services recently proposed (and developed in conjunction with the NAIC). If motivated, insurance regulators could easily draft analogous disclosures in the life insurance arena. Indeed, extensive work already exists on how regulators could design and implement disclosures for cash value life insurance policies that would allow consumers to effectively compare the cost and expected rate of returns of different policies.[9]

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[8] New York Regulation 194, codified at 11 NYCRR Part 30.
[9] See Joseph Belth, *Information Disclosure to the Life Insurance Consumer*, 24 DRAKE LAW REVIEW 727 (1975); James H. Hunt, *Variable Universal Life Insurance: Is it Worth It Now?* (2007), *available at* http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/VariableUniversalLife2007ReportPackage.pdf.

Standardized, regulator-designed, disclosures have numerous important advantages over the generic buyers' guides and broad standards currently relied upon in life insurance regulation. Most importantly, they recognize the fact that consumers have a limited capacity and willingness to compare complex financial instruments and they affirmatively assist consumers in making decisions. Additionally, because they are standardized and developed by regulators, they can be tested for effectiveness. They give consumers an incentive to invest in learning how to use disclosures, because they are consistent in content and design across companies. And they are relatively easy to police, compared to approaches that give companies discretion to disclose in any manner consistent with broad standards.

In sum, the lack of transparency in consumer-oriented property/casualty and life insurance markets is immensely troubling. To put it bluntly, insurance regulators have failed in a core feature of consumer protection. Transparency is fundamental to the operation of efficient markets: it allows consumers to make decisions consistent with their preferences and forces firms to adjust the products and practices to meet these preferences. Indeed, transparency is ultimately at the heart of recent reforms in the domains of consumer credit and health insurance. And while these reforms have surely been controversial, even their critics have tended to embrace the idea that effective competition requires open and transparent markets.