

**OVERSIGHT OF THE PROPERTY  
AND CASUALTY INSURANCE INDUSTRY**

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**HEARING**

BEFORE THE

**COMMITTEE ON COMMERCE,  
SCIENCE, AND TRANSPORTATION**

**UNITED STATES SENATE**

**ONE HUNDRED TENTH CONGRESS**

**FIRST SESSION**

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**APRIL 11, 2007**  
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## CONTENTS

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	Page
Hearing held on April 11, 2007 .....	1
Statement of Senator Klobuchar .....	71
Statement of Senator Lott .....	62
Statement of Senator Nelson .....	82
Statement of Senator Pryor .....	1

### WITNESSES

Bowman, Julie Benafield, Insurance Commissioner, State of Arkansas; Member, National Association of Insurance Commissioners .....	14
Prepared statement .....	16
Hood, Hon. Jim, Attorney General, State of Mississippi .....	3
Prepared statement .....	5
Hunter, J. Robert, Director of Insurance, Consumer Federation of America .....	22
Prepared statement .....	23
Regan, David W., Vice President, Legislative Affairs, National Automobile Dealers Association .....	54
Prepared statement .....	56

### APPENDIX

Calvin, Michael R., Interim President and CEO, American Association of Motor Vehicle Administrators, prepared statement .....	87
Response to written questions submitted by Hon. Maria Cantwell to:	
Julia Benafield Bowman .....	94
J. Robert Hunter .....	97
The National Association of Realtors, prepared statement .....	90



## **OVERSIGHT OF THE PROPERTY AND CASUALTY INSURANCE INDUSTRY**

**WEDNESDAY, APRIL 11, 2007**

U.S. SENATE,  
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,  
*Washington, DC.*

The Committee met, pursuant to notice, at 9:22 a.m. in room SR-253, Russell Senate Office Building, Hon. Mark Pryor, presiding.

### **OPENING STATEMENT OF HON. MARK PRYOR, U.S. SENATOR FROM ARKANSAS**

Senator PRYOR. Well, let me go ahead and call the hearing to order.

I want to thank my colleagues for being here this morning. And I know we'll have a few more drift in. There's a lot going on on the Senate calendar today. We have a number of hearings and a number of things going on on the floor, so you'll see some Senators come and go here.

I'd like to thank our panel of witnesses. In fact, we originally had two panels, and Attorney General Hood and Commissioner Bowman have graciously agreed to just consolidate the two panels to make it, I think, easier on everybody. But I'd like to thank everybody for being here. Mostly what we're going to talk about today is the property and casualty insurance industry. I think everything's fair game, but generally the focus is property and casualty lines of insurance.

We want to really look at the industry and look at the insurance markets in the U.S. to make sure the industry's healthy—that it's doing the things it's doing—that customers and consumers are being served here all over the country.

I'd like to thank Senator Inouye for allowing me to chair the hearing this morning. He invited a number of witnesses today, many of whom said yes. And we appreciate your being here.

I will note that we did try to invite a number of property and casualty associations to appear today. Some had conflicts, some felt like this might be an unfriendly venue for them, which is unfortunate. We're not going to name any names, Senator Lott. But—  
[Laughter.]

Senator PRYOR. Anyway, for various reasons, none of them were able to appear today, but they have been invited, and we want you to know that they were invited. We wanted to give them a chance to speak their piece.

I would like to just make my remarks very, very quickly, and then allow the panel to give their remarks. We have a couple of

Senators here who have to slip out and cover some other hearings at which either they will chair or the ranking members will have to introduce someone, et cetera. So, let me just be very brief.

You know, we had a terrible hurricane season in 2005. There were lots and lots of homes and personal property that were damaged all over the Gulf Coast and this country. However, 2005 proved to be one of the most profitable years for the insurance industry. Property and casualty insurers earned an unprecedented profit of \$28 billion in 2006, reversing a net loss of \$5.4 billion in 2005. Policyholder surplus grew for the fourth straight year in 2006 to approximately \$498 billion, up 13½ percent from approximately \$439 billion. While the profitability of the industry is not in question, the treatment of customers, policyholders, consumers, by the property and casualty insurance industry has raised some flags.

We have heard, in my office—and I'm sure every Senator in the Senate today has heard—complaints of various kinds from constituents about how they've been treated by their insurance companies. And I'm sure that some of these are very valid, some of them, you know, may just be based on misunderstandings or a misreading of the contract, et cetera. So, we certainly understand that. But we know that the insurance industry is a very important industry for this country. There are lots of issues that relate to insurance. It's an important part of our Nation's economy. It's very important to citizens all over this country, and, truly, all over the world.

So, with that, what I would like to do is just acknowledge our panelists today, allow them to make some statements, and then, if we want to make some opening statements—but I know that there are some Senators that need to hurry on to a subsequent hearing. Would that be okay with my colleagues? Is that OK?

Let me just introduce them in the sequence that they'll speak, and then we'll give everybody 5 minutes to make an opening statement. If you could keep it brief, I know we would appreciate it. But I know you've come here, traveled a long distance, and have some important things to say.

First will be Attorney General Jim Hood. He's the Attorney General of the State of Mississippi. And I have a fondness in my heart for attorneys general, because I used to be one, before—

[Laughter.]

Senator LOTT. They all look alike.

[Laughter.]

Senator PRYOR. You know, before they kicked me out of that organization, I enjoyed being an attorney general.

Next, we have Julie Benafield Bowman. She's the Commissioner of the Arkansas Insurance Department. It's great to have you here. Then we have Dr. Robert Hunter, Director of Insurance for the Consumer Federation of America. And last, we have David Regan, Vice President, Legislative Affairs, National Automobile Dealers Association.

So, again, thank all of you all for being here.

Attorney General Hood, if you could open us up.

**STATEMENT OF HON. JIM HOOD, ATTORNEY GENERAL,  
STATE OF MISSISSIPPI**

Mr. HOOD. Thank you, Senator Pryor.

I thank your state very much for coming—for taking our people in who fled from the storm. And many of you—and from other states—you know, the bright spot in all of this has been how the church groups have come down and torn out sheetrock and done so much for our people on the Gulf Coast. And thanks to the Senate and Senator Lott for all the work that you've done, and getting us money to help us try to get on our feet down there for our homeowners and businesses.

There were actually three storms that we've had to experience as a result of Katrina—Katrina itself, when it hit. The insurance claims handling practices and their refusal to pay was the second storm. And now we're experiencing the third storm, and that is the astronomical cost increases of insurance premiums that are inhibiting our rebuilding efforts down on our Gulf Coast.

I'm, as Attorney General—Senator Pryor, you know very well—it seems like every 2 weeks, us attorneys general send y'all a letter requesting that the Federal Government not pre-empt State law. So, very seldom do we come to the Federal Government and ask for help. This is one of those situations, because we are dealing with an industry that our states are unable to properly regulate. And I'll give you Exhibit A, that being the way State Farm has treated the people of the State of Mississippi after the hurricane hit, and their—the way they've handled their practices.

I spoke, here, to the—a Congressional panel recently, and a lobbyist for—and Mark Racicot, I believe, was his name, was talking about that the state had intimidated State Farm, that an attorney general had attempted to prosecute them and bullied them, basically, a company of that size, which is ridiculous. And Senator Lott has a document, I think, that will show what actually was going on down on our Gulf Coast, and what the insurance companies were actually doing, and that is an exhibit that I believe he'll be talking with you a little about.

One I'd like to mention to you is Exhibit A and what State Farm did, and that's attached to my testimony here. It's a letter from State Farm, after—we had reached a settlement agreement with them, and part of the settlement agreement was that I not indict them for crimes in Mississippi. They had said all along they were going to stay in Mississippi and continue to write policies. But, you see, that's what was vital to us, because they're 33 percent of the market on the Gulf Coast, and they're 25 percent statewide. If I'd of indicted them, and they would have pulled out of the State of Mississippi, then we would have had a gap that could not have been filled. And they threatened the state. And this is why I want the Federal Government to step in, take away their antitrust provisions, and license them on a Federal level, because there have got to be some controls, because they, in the past, have had such power and strength, they can stomp their foot and people run away. As AG's know, we have a duty, no matter how much heat they crank up—they sent out letters. They didn't send me one. I'm actually a State Farm policyholder, myself. But, you know, the—one of their sentences is, is, "Simply put, we cannot continue to write new poli-

cies under a contract that is now being reinterpreted by the courts and certain elected officials.” They have attempted to—they’ve criticized Senator Lott, and tried to claim that just because it was his home, that he’s involved in this. He’s seen what has happened. He’s been on the ground—he’s got a document he is going to talk about—and seen some of the problems. And I appreciate Senator Lott standing up and fighting for his people down on our coast, and the people of Mississippi statewide, because, you see, when they pulled out, they stopped writing policies all over the State, stopped writing new in—new homeowners policies. And that impacted their own insurance agencies up in north Mississippi, where I’m from. They’re not able to do it. And it was just punishment. It was an attempt to intimidate the people of the State of Mississippi, particularly a Federal judge, who is senior status now, a very conservative Federal judge, who found that one of their provisions was void, the anti-concurrent cause provision, because it basically made the policy worthless. And, furthermore, he found what has been in Mississippi a State law of proximate cause for over 100 years, the burden of proof is on the—in an all-risk policy—is on the insurance companies. So, they’ve tried to intimidate the State, and that’s why we need Federal regulation.

Now, I’ve mentioned the fact that we have reached a—an initial settlement with State Farm in our State civil litigation. And, there again, part of that was to keep them within the State. But what they did, they tried to claim that we are the ones who are trying to change their contract. In fact, they changed their own policies by issuing what’s called a wind/water protocol. That is attached to my testimony as Exhibit C, I believe, and they—we had to transcribe it. But what it did, it went out September 15, and it changed the whole way the policy is written. It required them to dump off on the Federal taxpayers, through the Federal Flood Insurance Program, by changing—if you have Federal flood insurance—on page 2 of that transcript, you can clearly see—they require, if they—if you have flood insurance, then we don’t pay anything on wind. They make the Federal Government pay it all. And they don’t try to develop a percentage as to how much of it was wind. So, they’re not even—they’re not even, you know, honoring their own policies.

I mentioned the anti-concurrent clause provision that’s already been stricken. And I don’t like to complain. And I’m out of time. But I’d briefly like to suggest a couple of things that—and that’s what you asked me to do—as to what we, maybe, should try to develop, proposed solutions.

You know, I think what we should do is some kind of government all-risk, whether the government takes it or we require the insurance companies to take all the risk in every state, be licensed—in order to be licensed by the Federal Government, you would have to cover all risk in all states and spread that risk around. I’m a free-market person, and I’d rather see us, probably, do it that way. But if they won’t participate in that type of program, then maybe the Government needs to take it over and take wind versus water.

Because, you see, in closing, the bottom line is this. If there’s a slab out there, you can’t tell what took that property out. And the burden is on the insurance companies to prove that. And the rea-

son that we define a situation of wind versus water as a dichotomy that's false, and it's developed by the insurance industry, because what they can do in a situation, if it's a slab and they don't know, they dump over on us taxpayers. We're having to pay it anyway. So, at some point we need to settle this situation, one way or the other.

I appreciate your attention and for inviting me to be here, and I'll be glad to answer any questions that I'm able to.

Thank you.

[The prepared statement of Mr. Hood follows:]

PREPARED STATEMENT OF HON. JIM HOOD, ATTORNEY GENERAL,  
STATE OF MISSISSIPPI

*Overview*

Good morning, Mr. Chairman and Members of the Committee. Thank you for inviting me here today to discuss the availability and affordability of property and casualty insurance in the Gulf Coast and other coastal regions. My name is Jim Hood, and I am the Attorney General for the State of Mississippi. I am encouraged by the Committee's attention to this urgent matter.

We cannot solve the problems that face the insurance industry without understanding the true nature of those problems. The citizens of Mississippi are experiencing first-hand the overwhelming power of the insurance industry, an industry that cannot be effectively regulated by state insurance commissioners. Short of Federal criminal prosecutions, the industry is not, in practice, limited in any meaningful way by the Federal Government. The insurance industry is running wild.

Much of this debate has centered on the sanctity of contracts. For example, State Farm has complained that their policies are "now being reinterpreted by the courts and certain elected officials." [See Exhibit A] That would indeed be a problem, if it had actually occurred. What really happened is much different.

The Mississippi Attorney General's Office (hereinafter "MSAG") has learned that State Farm acted after Hurricane Katrina to create and implement three different tactics for denying coverage. These tactics are not set forth in the policies themselves. Homeowners could not agree to those conditions, because they were never made aware that requirements outside of their policies would be used to deny their coverage. On information and belief, these policies were not presented, for review, to our state's Insurance Commissioner. *State Farm's policies on the Mississippi Gulf Coast are not being "reinterpreted" by the courts and elected officials—they are being ignored altogether by the "good neighbors" who issued them.*

What remedy do these citizens have? Tens of thousands of Mississippians have failed to get any relief from State Farm's agents, catastrophe team members or mediators. To add insult to injury, our citizens are then criticized as being litigious when they turn to the courts for relief after they have been unable to get it any other way. Their former homes are ridiculed by disparaging references to houses built on sandbars. Somehow the homeowner's expectation of payment is preposterous, but the industry's decision to issue a policy on what they later decide is a risky property and collect premiums is not questioned. An honest assessment would acknowledge that Mississippians do not live on sandbars and hold insurers accountable for honoring policies they write. We also have to question the quality of the actuarial data used to set rates if the premiums charged are not related to actual risk.

Defenders of the industry brag that only 1 percent of Katrina claims are currently disputed, but fail to mention that the insurance industry defines "claim" as a demand for payment under an applicable policy. This definition conveniently omits the common scenario in which a homeowner reports wind damage for coverage under a wind policy, and State Farm denies that any wind damage occurred. The industry definition of a "resolved" claim seems, in many instances to be synonymous with "closed." Homeowners who participated in mediation and received ten cents on the dollar for their damages may have their cases counted as closed, but these are hardly satisfied customers. Self-reporting of customer satisfaction by the insurance industry cannot be taken at face value.

The MSAG has worked diligently to reach an agreement with State Farm that would encourage them to continue doing business in the State of Mississippi. Insurance Commissioner Dale's recent announcement of an agreement with State Farm to re-examine approximately 35,000 claims represents more than a third of the

claims recognized by State Farm in Mississippi. However, no extraordinary deals should be required here at all. State Farm has had nineteen months to evaluate and pay these claims. They do not need a deal with either the MSAG or the Insurance Commission in order to pay what they owe.

The remainder of this report will briefly outline the following:

- tactics State Farm used to circumvent contractual obligations;
- the impact of those tactics and other conduct on the National Flood Insurance Program (NFIP);
- lessons learned from Hurricane Katrina.

## **I. Tactics Used by State Farm to Circumvent Contractual Obligations**

### *A. A Combination of Tactics: Selective Application of Anti-Concurrent Causation Clauses and the Adoption of a Wind/Water Protocol*

Legal gymnastics in the form of anti-concurrent causation clauses and a wind/water protocol were employed by State Farm after the storm to deny coverage. Policy exclusions should be understandable to the agents selling the policies, the customers buying them, and the personnel interpreting them when a claim is made. The so-called “anti-concurrent causation clauses” and the water exclusions featured in Homeowners policies that became disputed after Katrina are excessively convoluted and confusing. Members of the Committee are urged to review Exhibit B for the comprehensibility of these provisions.

In August of 2006, the Honorable Judge L.T. Senter, Jr. of the U.S. District Court for the Southern District of Mississippi, Southern Division, found Nationwide’s anti-concurrent causation clause to be unacceptably vague in the *Leonard* case, pointing out that “[t]his reading of the policy would mean that an insured whose dwelling lost its roof in high winds and at the same time suffered an incursion of even an inch of water could recover nothing under his Nationwide policy—. . .—I do not believe this is a reasonable interpretation of the policy.”<sup>1</sup> An honest and realistic assessment of whether this language is likely to be applied consistently and fairly by employees and vendors with varying degrees of training and experience working under challenging circumstances, yields little certainty.

State Farm may have recognized this problem. A wind/water protocol issued September 13, 2005, instructed CAT workers, in under three pages, how to make coverage decisions. The protocol was prefaced with this explanation:

Because of the combination of wind and water damages many homes sustained from Hurricane Katrina, the following materials have been developed and are intended for use as a guide for handling various wind and/or water claims in Louisiana, Mississippi and Alabama.

[See Exhibit C]

Surely Homeowners policies issued by State Farm already contemplated that in a hurricane, a combination of wind and water damages could and would occur. The wind/water protocol was not available for policyholders’ review but it was, by its very language, designed to evaluate their right to coverage.

Notably, the protocol maintained the anti-concurrent causation clause, but only in certain situations. The second page of the protocol features the following language:

*Damage to Property Caused by Flood Waters with available Flood Policy:* Where wind acts concurrently with flooding to cause damage to the insured property, coverage for the loss exists only under flood coverage, if available . . .

[See Exhibit C]

*Stated differently, the protocol dictates that if damage is caused by both wind and water, the policyholder only gets paid if they have a flood policy. If they have a wind policy, they get nothing. Thus, the anti-concurrent causation clause is applied to deny claims of policyholders who have no flood insurance, and is used to shift the burden to the Federal Government through the NFIP. The burden on the NFIP is discussed at length in the next section.*

The insurance industry is quick to cite the need for predictability as a reason to exit the Mississippi market, but policyholders deserve predictability too. At the very least, their rights should be interpreted under the policies they sign, not protocols developed after the storm.

<sup>1</sup>*Leonard v. Nationwide Mutual Insurance*, 438 F. Supp. 2d 684, 689 (S.D. Miss. 2006).

*B. The Third Tactic: Introducing New Terminology after the Storm*

The most generic definition of a hurricane is a “tropical cyclone.” Thus the event of a hurricane is defined by a combination of wind and water. Reducing claims to a question of “wind versus water” is a simplification that reflects the insurance industry’s approach to claims and has little or nothing to do with the actual experience of a hurricane.

It is easy enough to neatly sort out which policyholders have purchased wind coverage, flood coverage, or both. Looking at a concrete slab that used to be a family home and determining with any reasonable degree of certainty that 50 percent of the damage was caused by wind and 50 percent was caused by water is a tall order, not to be undertaken lightly by under-qualified adjusters and/or rookie, or even seasoned, engineers. Individual lawsuits filed since Katrina have inevitably featured a battle of weather experts, but the actual decisions regarding causation of damage were not made onsite by professional weather experts. *Soliciting the advice of adjusters and engineers to determine whether a home was destroyed by “wind or water” makes any ensuing “investigation” more closely correlated with the availability of coverage than the factual findings of damage.*

After the storm, the MSAG received complaints from homeowners who were advised by State Farm employees or vendors that they could not recover for wind damage unless they demonstrated “discernible wind damage.” Placing the burden on the policyholder to prove the nature of the damage represents a departure from long-standing Mississippi law. The term “discernible wind damage” is not included in policy language or Mississippi law, which makes it a disturbing standard to use when determining whether a family will have their coverage denied and live indefinitely in a FEMA trailer. This is yet another illustration of how policyholders were unable to rely on the language in their actual policies because State Farm changed the rules.

## **II. Impact of These Tactics on the NFIP**

Wind and water occur together naturally in a hurricane, but not in insurance policies. Part of the challenge of keeping the NFIP and private insurers viable is untangling our understanding of these two forces of nature and either imposing a somewhat artificial division in order to allocate risk and assess damages or developing a unified approach that accurately reflects the reality of the destruction a hurricane can cause.

In our investigation, we found evidence that adjusters for E.A. Renfroe, working for State Farm, were dispatched to damage sites and instructed to determine whether the damage could be categorized as a slab, “popsicle stick,” or “cabana.” “Popsicle stick” is industry slang for a foundation with support pilings intact; a “cabana” is industry slang for a structure that maintains some degree of post and lintel support but is otherwise a skeleton due to water washing through.

Not much effort beyond riding past the property in a car and looking out the window would seem to be required to make this determination, but the fees for this adjusting “service” were passed along to the NFIP. Adjusters were instructed that if they found the property to be in one of these three conditions, they were to request that an engineering inspection be ordered to provide additional guidance in assessing the damage. This subsumes that the adjusters were not considered qualified or sufficient to make a final determination as to the cause of damage. However, many of these adjusters at this stage, without the benefit of an engineering report and often without the benefit of proper flood training and certification themselves, would go ahead and recommend maximum payment of flood coverage and contents through the NFIP.

So, to illustrate, a home is insured by State Farm under a homeowner’s policy for \$500,000 for structural damage and \$250,000 for contents; in addition the homeowner purchases \$250,000 of protection against structural damage due to flood and \$100,000 for contents due to flood pursuant to NFIP policies. An adjuster visits the damage, and determines that maximum coverage is available under the NFIP.

Software programs used by the industry to price home repairs and reconstruction are admittedly not regulated by the NFIP.<sup>2</sup> This can result, for example, in a claim against an NFIP policy, with a calculation of \$1.00 per square foot for drywall repair, and a companion claim under a Homeowners policy for the same property, calculating a drywall repair at \$0.60. The MSAG is also aware of at least one instance in which a list of contents submitted by the insureds bore no resemblance to the list of contents ultimately submitted by their insurance provider for payment on

<sup>2</sup>Associated Press. *Isabel Claims under Scrutiny*, *Baltimore Sun*, March 12, 2004, “NFIP claims director James Shortley said the program does not regulate the software that adjusters use, explaining, ‘We would have to verify prices in every little town.’”

that same claim to the NFIP. On the second list, items had been added, and values had been elevated to bring the claim up to the amounts needed to trigger coverage through the NFIP.

Continuing our illustration, the adjuster then advises the homeowner that further investigation will be needed to assess the extent of wind damage. However, by approving payment through the NFIP, the adjusters have already made a decision about the ratio of damage attributable to wind and that attributable to water. Unfortunately, the ratio is not based on the actual damage. It is based on the availability of coverage. Damage should be assessed first, then the availability of coverage. Reversing this order turns the entire premise of insurance on its head.

The claims adjusting process continues as an engineer may then visit the property and submit a report of damage to State Farm. The homeowners were not allowed to see these reports. Even though the report was requested in order to assist the adjuster's evaluation, the reports were not given to adjusters. The reports were not given to the claim representatives or even openly circulated within State Farm catastrophe offices. Records of whether and when engineering reports had been ordered and received were accessible only to a limited number of catastrophe employees, and the reports themselves were reviewed by only a handful of people.

The MSAG is not aware of any instances in which a professional engineer's conclusion established a ratio of wind to water damage that contradicted the initial assessment of flood damage by an adjuster. In fact, the engineering reports usually did not separate wind and water damage out into any sort of ratio or proportion at all. How then, is a relatively untrained adjuster considered qualified to do a perfunctory inspection and determine that the proportion of damage correlates with the limits on Federal flood policies?

*Clearly State Farm is willing to spend the NFIP's money with only nominal investigation, but is much more deliberate and hesitant to spend its own. This may explain why the industry experienced record-breaking profits last year and the NFIP is on track to be bankrupt by September of this year.*

### **III. Lessons Learned from Katrina**

What is the appropriate response of state and Federal Government when an insurance company simply disregards its contractual obligations? How can anyone accurately assess whether or not an insurance company can reasonably be expected to continue doing business in coastal areas without getting to the truth of how much a private insurer actually owed, and how much of that was improperly passed on to the NFIP? If another hurricane hits, and the insurance industry uses the same tactics they did after Hurricane Katrina, who can stop them? If the industry's anti-trust exemption is not revoked, we will probably be asking ourselves these same questions after the next disaster.

Insurers want to argue both that it is unreasonable to expect them to cover coastal areas and that government involvement is not warranted because it would "displace" private capital. If private industry continues to abandon the 130 million Americans who live in coastal regions, one could hardly say that private capital has been displaced. It has been withdrawn, and a vacuum exists that threatens the housing market and economic viability of significant parts of our country. One of the biggest benefits the insurance industry has to offer, the ability to capitalize risk and spread it globally, is completely absent in areas that have been abandoned after natural disasters. The industry opposes government intervention on the grounds that it will simply shift risk around, rather than spreading it, but Hurricane Katrina has shown us the industry's willingness to shift its own obligations onto the taxpayers supporting the NFIP.

The insurance industry has also asserted that the 2005 hurricane season wiped out premiums and underwriting for the last several years in Mississippi and Louisiana. If the premiums charged in Mississippi were not enough to cover the policies, then perhaps the inquiry should be into whether or not State Farm's actuaries anticipated implementing this scheme to maximize coverage under the NFIP when they recommended the rates in effect when Katrina hit.

Further, if homeowners can only expect to recover the amounts they paid in through premiums, what is the difference in what a private insurer can offer and a government-backed catastrophe savings account? Many of our citizens would have been overjoyed to recover the amounts they have paid in through premiums, but were denied even that modest a benefit of their bargain with insurance companies.

According to recent publicity by State Farm,<sup>3</sup> they have “handled” about 84,000 claims and paid out “over one billion dollars” in Katrina claims in Mississippi, excluding all payments made through the NFIP. That averages out to less than \$12,000 per claim and covers claims from an undisclosed number of Mississippi’s eighty-two counties. Insurance Commissioner Dale’s agreement, under which State Farm will “re-examine” approximately 35,000 claims and “make millions of dollars available” may give the appearance of relief, but guarantees policyholders nothing but another opportunity to be exploited by State Farm.<sup>4</sup> If State Farm could not make an accurate determination of the cause of damage right after Hurricane Katrina, how will they do a better job after nineteen months of cleanup and rain?

The industry’s reverence for contracts is again belied by this widespread practice of engaging policyholders in wrangling for months or years to eventually have a small portion of their claim paid as a “settlement.” People who have survived natural disasters are in no position to negotiate their insurance coverage after the fact, but this is exactly what they are being required to do.

Payment of claims is a contractual obligation but is frequently treated as a benevolent gift from the insurer to the insured. Katrina has shown us that the regulatory status quo is not adequate to protect policyholders’ contractual rights.

#### IV. Conclusion

The MSAG’s office has, in good faith, engaged in tireless efforts to work with State Farm to make insurance affordable for our citizens. However, we recognize that accepting premiums is not the same thing as “doing business.” If a State Farm insurance policy is nothing more than a meaningless security blanket, then Mississippians do not benefit from having them stay in the state to collect premiums. As the struggle in our state and throughout the country demonstrates, insurance companies are free to take the money and run from the market whenever they choose. At the same time, prospective homeowners are unable to get federally-backed mortgages without purchasing homeowners insurance. It is for this reason that a discussion of free markets is not entirely appropriate when applied to a product that people are legally required to buy.

No easy reconciliation of the competing interests in this discussion can be made, but Congress urgently needs to take actions to keep homeowners from losing faith in the insurance industry altogether. Consumers who faithfully pay their premiums should not have to wonder why, after nineteen months of inspections, mediations, phone calls and letters, they are no better off than those who did not buy insurance at all. If the industry wants to serve coastal areas, they must be held accountable, just as any other business would be. The antitrust exemption provided by McCarran-Ferguson has yielded outrageous results. If the industry pulls out of coastal areas, it cannot then object to the government’s response in assisting an abandoned segment of the population. Thank you for inviting me today. I look forward to your questions.

#### *Exhibit List:*

Exhibit A—Letter issued to State Farm customers stating it will no longer offer new homeowners policies to Mississippians.

Exhibit B—Anti-Concurrent Causation language found in homeowners insurance policies issued by Allstate, Nationwide and State Farm.

Exhibit C—Wind/Water Protocol issued by State Farm on September 13, 2005.

#### EXHIBIT A

STATE FARM INSURANCE  
Duluth, GA

LYNN GUNN  
Pelahatchie, MS.

Dear Lynn,

Recently, State Farm® announced it will no longer offer *new* homeowners or commercial insurance policies in Mississippi. This decision certainly didn’t come easily or quickly—it’s unfortunate, but necessary. The unpredictable legal and political environment in the state leaves us unable to accept any additional risk in the Mississippi homeowners market. Simply put, we cannot continue to write new policies

<sup>3</sup>State Farm® Announces It Will Suspend Writing Homeowners and Commercial Policies in Mississippi. [http://www.statefarm.com/about/media/media\\_releases/mississippi\\_home.asp](http://www.statefarm.com/about/media/media_releases/mississippi_home.asp). 4/2/2007.

<sup>4</sup>Associated Press, *Insurance Regulator Says State Farm Agrees to Re-examine Hurricane Cases*. USA Today, March 19, 2007.

under a contract that is now being reinterpreted by the courts and certain elected officials.

We've built our business by talking to people and by establishing relationships and helping them protect what they value most. Rest assured, that's what we will continue to do.

You are a valued customer with whom I'm proud to call this state home. We want to work with you to make Mississippi stronger and more vibrant than ever before. While we cannot offer homeowners or commercial insurance policies in addition to the ones you already own, we look forward to meeting your insurance and financial services needs through the more than 70 other products State Farm offers. These include auto, life and health insurance, as well as a variety of financial services.

I invite you to call your State Farm agent with questions you may have about what I've shared in this letter, or about what you may read or hear in the news. It is an honor for us to serve you. I appreciate your business and your loyalty.

Sincerely,

G. WEBB HOWELL  
State Farm Vice President—Agency

EXHIBIT B

Taken from Allstate Property and Casualty Insurance Company Deluxe Homeowners Policy, *Elmer and Alexa Buente v. Allstate Insurance Company et al*, Civil Action 1:05CV712 LTS-JMR, U.S. District Court, S.D. Miss., Judge Senter's Memorandum Opinion, March 24, 2006.

With respect to the insured dwelling (Section I, Coverage A) and other structures (Section I, Coverage B):

Losses We Do Not Cover . . .

We do not cover loss to the [insured] property consisting of or caused by:

1. Flood, including but not limited to surface water, waves, tidal water, or overflow of any body of water, or spray from any of these, whether or not driven by wind.

\* \* \* \* \*

4. Water or any other substance on or below the surface of the ground, regardless of its source. This includes water or any other substance which exerts pressure on, or flows, seeps or leaks through any part of the residence premises.

\* \* \* \* \*

21. Weather conditions that contribute in any way with a cause of loss excluded in this section to produce a loss.

\* \* \* \* \*

23. We do not cover loss to property . . . when:

- (a) there are two or more causes of loss to the covered property; and
- (b) the predominant cause(s) of loss is (are) excluded under Losses We Do Not Cover, items 1 through 22 above.

With respect to personal property (Section I, Coverage C, Personal Property Protection):

Losses We do Not Cover . . .

We do not cover loss to [insured personal] property caused by or consisting of:

1. Flood, including, but not limited to surface water, waves, tidal water or overflow of any body of water, or spray from any of these, whether or not driven by wind.

\* \* \* \* \*

4. Water or any other substance on or below the surface of the ground, regardless of its source. This includes water or any other substance which exerts pressure on, or flows, seeps or leaks through any part of the residence premises.

\* \* \* \* \*

13. Weather conditions that contribute in any way with a cause of loss excluded in this section to produce a loss.

\* \* \* \* \*

15. We do not cover loss to [insured personal] property when:

- (a) there are two or more causes of loss to the covered property; and
- (b) the predominant cause(s) of loss is (are) excluded under Losses We Do Not Cover items 1 through 14 above.

Taken from Nationwide homeowners insurance policy, *Paul Leonard and Julie Leonard v. Nationwide Mutual Insurance Company*, Civil Action No.1:05 CV475 LTS-RHW, U.S. District Court, S.D. Miss., Judge Senter’s Memorandum Opinion, August 15, 2006.

Section 1, Property Coverages  
 Coverage A—Dwelling  
 Coverage B—Other Structures  
 Coverage C—Personal Property  
 Property Exclusions, Section 1

1. We do not cover loss to any property resulting directly or indirectly from any of the following. Such a loss is excluded even if another peril or event contributed concurrently or in any sequence to cause the loss.

\* \* \* \* \*

(b) Water or damage caused by water-borne material. Loss resulting from water or water-borne material damage described below is not covered even if other perils contributed, directly or indirectly to cause the loss. Water and water-borne material damage means:

- (1) flood, surface water, waves, tidal waves, overflow of a body of water, spray from these, whether or not driven by wind.

\* \* \* \* \*

(n) Windstorm or hail to any:

- (1) structure, other than a building, including the supports and screens, with a roof-like covering of cloth, metal, plastic or fiberglass, whether or not the structure is attached to a building.
- (2) screens, including their supports, around a pool, patio or other areas.
- (3) property lines and similar walls, including seawalls, greenhouses, hot-houses, slathouses, trellis, pergolas, cabanas and outdoor equipment used to service the residence premises.
- (4) structure, including property in or on the structure, which is in whole or part, in or over water.

2. We do not cover loss to any property resulting directly or indirectly from the following if another excluded peril contributes to the loss:

\* \* \* \* \*

(c) Weather conditions, if contributing in any way with an exclusion listed in paragraph 1 of this Section.

Taken from State Farm homeowners policy, *John Tuepker and Claire Tuepker v. State Farm Fire & Casualty Company*, Civil Action No. 1:05CV559 LTS-JMR, Judge Senter’s Memorandum Opinion, May 24, 2006.

Section I, Losses Insured  
 Coverage A—Dwelling  
 Coverage B—Personal Property  
 Section I—Losses Not Insured

1. We do not insure for any loss to the property described in Coverage A which consists of, or is directly and immediately caused by, one or more of the perils listed in items a. through n. below, regardless of whether the loss occurs suddenly or gradually, involves isolated or widespread damage, arises from natural or external forces, or occurs as a result of any combination of these:

- a. collapse, except as specifically provided in Section I Additional Coverages, Collapse.

\* \* \* \* \*

2. We do not insure under any coverage for any loss which would not have occurred in the absence of one or more of the following events. We do not insure

for such loss regardless of: (a) the cause of the excluded event; or (b) other causes of the excluded event; or (c) whether other causes acted concurrently or in any sequence with the excluded event to produce the loss; or (d) whether the event occurs suddenly or gradually, involves isolated or widespread damage, arises from natural or external forces, or occurs as a result of any combination of these:

\* \* \* \* \*

c. Water Damage, meaning:

(1) flood, surface water, waves, tidal water, tsunami, seiche, overflow of a body of water; or spray from any of these, all whether driven by wind or not;

\* \* \* \* \*

3. We do not insure under any coverage for any loss consisting of one or more of the items listed below. Further, we do not insure for loss described in paragraphs 1 and 2 immediately above regardless of whether one or more of the following: (a) directly or indirectly cause, contribute to or aggravate the loss; or (b) occur before, at the same time, or after the loss or any other cause of the loss:

\* \* \* \* \*

c. weather conditions.

However, we do insure for any resulting loss from items a., b., and c. unless the resulting loss is itself a Loss Not Insured by this Section.

EXHIBIT C

September 13, 2005

State Farm Claim Associates handling CAT FL in the Central and Southern Zones Property and Casualty Claim Consulting Services

RE: WIND/WATER CLAIM HANDLING PROTOCOL

Action Required

Summary

Because of the combination of wind and water damages many homes sustained from Hurricane Katrina, the following materials have been developed and are intended for use as a guide for handling various wind and/or water claims in Louisiana, Mississippi and Alabama.

Action

The protocol below outlines the process that should be used for determination of coverage in those locations.

Protocol Detail

Each claim should be handled on its merits. A causation investigation should be conducted and appropriate claim file documentation is required. Any available information should be considered in making a coverage determination. This information will include, but is not limited to:

- Evidence gathered at the onsite inspection. This includes documentation of physical evidence such as water lines, an examination of the debris, and an analysis of the physical damage to the structure.
- Evidence gathered at neighboring locations.
- Information from witnesses and policyholders.
- Input from experts that may be retained to provide guidance.

The damage to insured properties will fall into the following categories and should be handled as detailed below:

- Damage to the property was caused by windstorm.
- Damage to separate portions of the property can be attributed to either windstorm or excluded water.
- Damage to the property was caused by excluded water; with no available coverage.

- Damage to the property was caused by flood waters; covered by an available flood policy.

*Damage Caused by Windstorm*

When the investigation indicates that the damage was caused by windstorm, the claim will be handled under the applicable provisions of the involved property policy. Consideration should be given to determine if a hurricane deductible or a windstorm hail exclusion endorsement is involved and the claim handled accordingly.

*Damage to Separate Portions with Distinguishable Wind and Excluded Water*

Each type of damage should be documented in the claim file. The claim representative should calculate the separate damage attributable to each peril and handle the adjustment accordingly. In those cases where the policyholder has policies for both a windstorm and a flood, payments should be issued under the applicable policy.

*Damage Caused by Excluded Water*

When the investigation indicates that the damage was caused by excluded water and the claim investigation does not reveal independent windstorm damage to separate portions of the property, there is no coverage available under the homeowners policy pursuant to the following language in Section 1 Losses Not Insured:

“2. We do not insure under any coverage for any loss which would not have occurred in the absence of one or more of the following excluded events. We do not insure for such loss regardless of: (a) the cause of the excluded event; or (b) other causes of the loss; or (c) whether other causes acted concurrently or in any sequence with the excluded event to produce the loss; or (d) whether the event occurs suddenly or gradually, involves isolated or widespread damage, arises from natural or external forces, or occurs as a result to any combination of these:

\* \* \* \* \*

c. Water Damage, meaning:

(1) flood, surface water, waves, tidal water, tsunami, selche, overflow of a body of water, or spray from any of these, all whether driven by wind or not . . .”

Other Losses Not Insured may be applicable, including 2.c.(2) and (3), 3.(a), (b) and (c).

*Damage to Property Caused by Flood Waters with Available Flood Policy*

Where wind acts concurrently with flooding to cause damage to the insured property, coverage for the loss exists only under flood coverage, if available. The flood damage claim should be handled consistent with the terms of the flood policy providing coverage as outlined in Operation Guide 71-06.

*Claims Where the Causation Investigation is Ongoing*

Payment can be made under a reservation of rights for ALE or Loss of Income under the property policy until the final coverage decision is made. The policyholder should be advised in writing that:

- The investigation is ongoing.
- No coverage decision has been made.
- In the event it is determined that there is no covered damage, no further payment will be made on ALE or Loss of Income.
- They may undertake an independent investigation.

All claims in this category must be reviewed by the Claim Team Manager before a final decision is made. Management should be involved in any claim where it is deemed necessary to retain an expert to assist in the determination of causation.

**For More Information**

Any question on this protocol should be directed to your Claim Team Manager.

cc. P & C Claims Executive  
 Southern Zone Executive and Claim Managers  
 Central Zone Executive and Claim Managers  
 P & C Claims Directors and Consultants  
 Catastrophe Services Claim Managers  
 Catastrophe Services Section and Team Managers  
 Zone Section Managers

Senator PRYOR. Thank you.  
Ms. Bowman?

**STATEMENT OF JULIE BENAFIELD BOWMAN, INSURANCE  
COMMISSIONER; STATE OF ARKANSAS; MEMBER, NATIONAL  
ASSOCIATION OF INSURANCE COMMISSIONERS**

Ms. BOWMAN. Thank you.

Chairman Pryor, Vice Chairman Stevens, Senator Lott, Senator Vitter, thank you very much for the opportunity to testify here today.

Thank you. I usually don't need a mike. I'm usually told I had a big mouth anyway, but I'll use it.

I was asked to testify today on the role of insurance commissioners in regulating the property and casualty insurance industry, the financial health of the property and casualty insurance industry, and its market activities, such as pricing, underwriting, and settling claims.

As the Insurance Commissioner for the State of Arkansas, I'm also a member of the National Association of Insurance Commissioners.

Related to the topic matter today, I am—I serve as the Vice Chair of the National Association of Insurance Commissioners, Market Regulation and Consumer Affairs Committee, and am a member of various task forces at that Committee level.

I'll provide you, today, with my perspective, to help you understand how insurance regulators protect consumers, and, in my view, on the health of the property and casualty insurance industry and their market activities.

The first thing, and most important job of an insurance commissioner, is consumer protection. That's our first goal. That's the mission of an insurance commissioner. That's the first thing we look at. And this is accomplished by maintaining strong, cooperative regulatory oversight of insurers' solvency and monitoring insurer marketing activities so that a healthy, competitive marketplace exists to serve consumers.

In its simplest form, insurance regulation is about two things. The primary job of an insurance regulator is to make sure that insurance companies remain solvent so that they can pay the claims as they become due, and to make sure that insurers treat their customers and claimants fairly.

Second, there's a misunderstanding about what constitutes an insurance market and how insurers go about serving their markets. One could assume that each State has a single marketplace, but that's probably inaccurate. For example, in Arkansas, we don't spend a whole lot of time worrying about hurricanes. I think my fellow commissioners in the Gulf States spend a lot of time worrying about hurricanes and how to finance those problems. Our property insurance writers are more concerned about earthquakes, tornado—I mean, earthquakes, tornados, lightning, hail, those type issues. Certainly, those can be very devastating. We have a lot of earthquake risk, because of the New Madrid Fault in Arkansas.

And, while you might view Arkansas as a small State, from an insurance perspective, it's really not. We have two distinct insurance markets when it comes to personal lines: in auto insurance,

as well as home insurance—homeowners' insurance. Little Rock is an urban area which is very different from the rural areas of Arkansas, so there's a lot of difference when you're looking at insuring automobile liability in the Little Rock area and homeowners' insurance in the Little Rock area, as to those rural areas in Arkansas. As I mentioned earlier, the eastern part of our State has the earthquake exposure that is very different from the western portions of Arkansas.

Third, in spite of paying for the record levels of catastrophes in 2004 and 2005, as Senator Pryor mentioned, the financial health of the property and casualty insurance industry has never been better. It is safe to say that 2006 was a very good year for the U.S. property and casualty insurance industry. There were no hurricanes that made landfall in 2006, and other catastrophe losses were low. The lack of major catastrophes, combined with favorable market pricing conditions, led to a record year for insurers. The industry posted an underwriting gain of over \$34 billion, and it achieved its lowest combined ratio in years, estimated to be 92.6 percent. Let me explain that just a little bit.

The combined ratio is a way to determine if insurers made money on their insurance operations, with 100 percent combined ratio being at the breakeven point. So, we look at 100 percent being the breakeven point. So, a combined ratio below 100 percent means that the underwriting part of the business was profitable. Remember, I said that their combined ratio was 92.6 percent, well below the 100 percent that's the marker.

In addition in—to making money on underwriting, insurers also make money on their investments. Between underwriting results and their investment results, the property and casualty industry's policyholder surplus grew to almost \$480 billion. So, the property and casualty industry is very healthy, despite the losses that they received year before last.

Finally, I will comment on insurer pricing, rate regulation, and insurer practices related to claim settlement and underwriting.

In particular, I would like to explore some myths that are promoted by some who hope that you would do away with State-based regulation, or at least offer them a choice of regulatory frameworks. You will probably hear from industry representatives that rate regulation causes them to be less competitive than they might be otherwise. They generally refer to rate regulation as price control. This is an inaccurate term. The process in almost all States for virtually all insurance products written by property and casualty insurers starts with the insurance company actuaries preparing a rate-change proposal, and providing it to insurer management. Management considers the input from their actuaries and their marketing people, and they decide whether a rate filing will be submitted. And then, if so, how much that rate filing might be. That rate filing has been prepared and submitted to the regulator, to the insurance commissioner. In some cases, it must be approved by the regulator in advance. Most States, though, and in many lines of business, it doesn't. For example, in Arkansas, the personal lines, and most small commercial lines, the rates would be filed, and the insurers would be able to use them within 20 days, as long as the markets are competitive. Prior approval would only be re-

quired if I were to find that the particular market is noncompetitive. In Arkansas, workers' comp is subject to prior approval, as well as medical malpractice. Those rates are subject to prior approval. Otherwise, it's a file and use. Insurers that write large commercial risk would not even be required to make a filing.

Insurers often maintain that price controls make them non-competitive. I think you will agree that the financial performance of the property and casualty industry in recent years makes these statements ring hollow. I expect that some witnesses will agree with these statements and suggest that insurance regulators should do more to lower prices, and I would welcome any questions you have about the industry and regulation of the property and casualty industry.

[The prepared statement of Ms. Bowman follows:]

PREPARED STATEMENT OF JULIE BENAFIELD BOWMAN, INSURANCE COMMISSIONER;  
STATE OF ARKANSAS; MEMBER, NATIONAL ASSOCIATION OF INSURANCE  
COMMISSIONERS

Chairman Inouye, Vice Chairman Stevens, Senator Pryor and Members of the Committee, thank you for the opportunity to testify here today on the role of insurance commissioners in regulating the property and casualty insurance, the financial health of the property and casualty insurance industry, and its market activities such as pricing, underwriting and settling claims.

My name is Julie Bowman. I am the Insurance Commissioner for the State of Arkansas and an active member of the National Association of Insurance Commissioners (NAIC). Related to the topic matter of today's hearing, I serve as Vice Chair of the NAIC's Market Regulation and Consumer Affairs Committee and am a member of the Workers' Compensation Task Force, the Speed to Market Task Force, the Operational Efficiencies Working Group.

Today I would like to provide my perspective to help you understand how insurance regulators protect consumers and my views on the health of the property and casualty insurance industry and their market activities.

- First, the most important job of an insurance commissioner is to protect insurance consumers. This is accomplished by maintaining strong, cooperative regulatory oversight of insurer solvency and monitoring insurer marketing activities so that a healthy competitive marketplace exists to serve consumers.
- Second, there is misunderstanding about what constitutes an insurance market and how insurers go about serving the markets that they choose to serve.
- Third, in spite of paying for record levels of catastrophes in 2004 and 2005, the financial health of the property and casualty insurance industry has never been better.
- Finally, I will comment on insurer pricing, rate regulation, and insurer practices related to claim settlement and underwriting. In particular I would like to explore some myths that are promoted by some who hope that you would do away with state-based insurance regulation or at least offer them a choice of regulatory frameworks.

#### **Insurance Regulation and Consumer Protection**

The most important job of an insurance commissioner is to protect insurance consumers. This is accomplished by maintaining strong, cooperative regulatory oversight of insurer solvency and monitoring insurer marketing activities so that a healthy competitive marketplace exists to serve consumers.

In its simplest form, insurance regulation is about two things. The primary job of an insurance regulator is to make sure that insurance companies remain solvent so that they can pay claims as they become due and to make sure that insurers treat their customers and claimants fairly. An insolvent insurer does not have the resources to pay its claims and therefore, is of no use to either its policyholders or those with claims against them. A recalcitrant insurer that fails to comply with state consumer protection laws and regulations also can be a problem if it fails to deliver the expected insurance benefits to consumers at times when they are needed the most.

The goal of financial regulation is protecting consumers against excessive insurer insolvency risk. Insurance regulators protect the public interest by requiring insurers to meet certain financial standards and taking remedial action when needed. Congress has chosen to leave the regulation of insurers to the states under the terms specified in the McCarran-Ferguson Act, and state legislatures have created regulatory frameworks in state law to address financial regulation. A typical state would have capital adequacy standards that would include minimum capital and surplus requirements to protect policyholders and claimants against unexpected increases in liabilities and decreases in the value of assets held by insurers. In addition, states also use a risk-based capital test that more specifically measures the risks each insurer assumes. Risk-based capital is intended to provide capital adequacy standards that are related to risk, that raise the safety net for insurers, that are uniform among states and that provide for regulatory action when actual capital falls below the standard.

States also have enacted legislation that regulates the reserves that an insurer is obligated to set aside for future claims payments. One of the uncertainties for property and casualty insurers is to determine the reserves needed for claims that have already occurred, but not yet paid. Regulators review insurer financial statements and actuarial opinions to assess whether insurers are establishing adequate reserves for unpaid losses.

There are investment restrictions specified in state laws. State laws take a conservative approach to insurer investments with most states limiting the amount of investments an insurer can make in non-investment grade assets. State regulators work collectively through the NAIC's Securities Valuation Office (SVO) to monitor the assets held by insurers. The SVO assigns a credit rating to assets that are not otherwise rated by a rating agency such as Standard & Poors or AM Best. This function helps state examiners with their evaluation of the assets that an insurer holds as part of a financial examination.

These regulatory requirements are of little value if there is no mechanism in place to monitor insurers' compliance with the requirements. The purpose of solvency monitoring is to ensure that insurance companies are meeting regulatory standards and to alert regulators if action is needed to protect policyholders' interests. State regulators have established a vast solvency monitoring system that encompasses a range of regulatory activities, including financial reporting, early-warning systems, financial analysis and onsite insurer examinations. Annual and quarterly financial statements filed by insurers serve as the principle source of information to assess insurer financial position. Insurers generally are examined every 3 years. States coordinate the financial examinations through the NAIC association-wide or zone exams process to avoid duplicative or redundant examinations of the same insurer.

State insurance regulators have developed a certification program for insurance departments. The goal of the certification process is to ensure that a state's solvency regulation meets certain minimum requirements so that other jurisdictions can have a degree of confidence in the state's financial oversight of its domestic insurers. Adopted in 1990, the NAIC's Financial Regulation Standards and Accreditation Program establishes standards that states must meet to become accredited. Each insurance department's financial regulatory framework and monitoring program is reviewed by an independent review team that assesses the department's compliance. A compliance review will look at three areas: laws and regulations; regulatory practices and procedures; and organizational and personnel practices. States that pass the review are recognized as accredited states.

Market regulation deals with insurer pricing, product development and market practices. If insurers are able to use their market power to raise prices above competitive levels, then regulators can improve market performance by setting a price ceiling at the competitive price level. This rarely happens as the competitive structure of most markets prevents insurers from acquiring significant market power.

Market regulation also encompasses review of contractual language before it is sold to consumers. This basic consumer protection helps both the insurer and the policyholder by having an expert state employee review the insurance contract before the transaction with the policyholder. Property and casualty insurance contracts are based in state laws and regulations. State regulators with expertise in the state's civil justice system and requirements enacted by the state legislature review the contract for statutory compliance.

Another form of market regulation is the market analysis and market conduct examination process. Market analysis is about the collection of data and review of it to determine if insurers are treating policyholders and claimants fairly. Market conduct examinations are called if the regulator suspects that an insurer is failing in this duty. Some market conduct exams are done without suspicion of wrong doing. In this type of exam, a regulator would review a sampling of claims files to see that

statutory timeliness requirements are met and that the insurer provided the claimant with a reasonable settlement in accordance with the policy provisions.

### **Insurance Markets**

While the rest of the world thinks of the United States as having the largest insurance market, it is not a single marketplace but rather a combination of smaller markets that, when aggregated, yield a \$1.35 trillion "marketplace." In comparison, the insurance market in Japan is roughly \$475 billion and the U.K. is \$300 billion. The largest state market is California with \$124 billion in written premiums. Only Japan, the U.K., France Germany and Italy have larger markets than California. Following California is New York with \$116 billion, Florida with \$92 billion and Texas with \$82 billion. Of the top ten jurisdictions in the world, four are the states previously mentioned. My state, Arkansas, has \$8.6 billion, slightly less than Poland and Mexico, but larger than the insurance markets in Argentina, Turkey, Israel and Thailand.

One could assume that each state has a single marketplace, but even that comparison is inaccurate. For example, in Arkansas, we do not spend much time worrying about hurricanes. I know my fellow commissioners in the Gulf States spend a great deal of time thinking about them and how to finance the devastating losses that they cause. Our property insurance writers are more concerned with tornados, lightning and hail. We also have some earthquake risk as we are exposed to the New Madrid Fault. Although you might view Arkansas as a small state from an insurance perspective, we have two distinct insurance markets when it comes to personal lines policies such as auto insurance and homeowners insurance. Little Rock is an urban area with different market dynamics than the rural areas of the state. As I mentioned earlier, the Eastern part of our state has earthquake exposure that is different from the Western portions of the state.

Since insurance markets are different, insurers approach them in different ways. Citizens in Western Arkansas have no difficulty obtaining earthquake coverage, while the Eastern residents, particularly those living near the fault line, have recently experienced some availability problems and the prices for the coverage, when offered, have risen sharply. In most of the country, for most lines of business, insurance is a voluntary offering by a private enterprise with the intent that the insurance sold will generate sufficient revenues to pay all claims and expenses with a little bit left over to provide a profit for the owners. Sometimes the public misperceives that they have a right to obtain insurance.

We do have some obligation to make sure that our citizens can obtain the essential insurance coverages that they need. Most state governments require that citizens buy auto insurance if they wish to operate a motor vehicle. Banks and other lending institutions generally require the purchase of property insurance as a condition for obtaining a loan. Thus, it is in the public's interest for government to take steps to see that all citizens are served by making available auto insurance and property insurance to those that need it. When the private sector chooses not to serve a market, the states generally have stepped in and created a residual market to meet that pressing need. A variety of types of residual market mechanisms are available in the states, including FAIR plans, catastrophe funds, assigned risk plans and joint underwriting associations.

Nationwide, the property and casualty insurance market for individuals and businesses is healthy and competitive. It has been well recorded that, despite record catastrophic losses, the industry is also enjoying record profits. However, there are some coastal regions of the country where the insurance market is in crisis, due largely to insurers' reluctance to provide insurance in areas of perceived high risk and, subsequently, the reinsurance costs associated with those areas. It is important for you to know that insurance costs are not going up directly to recoup the losses of 2004 and 2005. They are going up because the losses of 2004 and 2005 have demonstrated a level of risk potential for the future that has insurers rethinking what their prospective losses will be going forward. When an insurer suffers a 1-in-500 year event in consecutive years, it rightly begins to question the validity of its models and risk management assumptions, and adjusts its future expected losses accordingly. At the same time, reinsurers are drawing those same conclusions, which add to the overall price increase.

In terms of what areas of the country are suffering an insurance crisis, another important distinction is the difference between coastal states and coastal regions within those states. Most coastal states, perhaps with the exception of Florida, have a relatively healthy property and casualty market in the vast majority of the state. Even in Florida the auto insurance market is performing well; however, the property insurance market is troubled. In Alabama, only 2 of the 67 counties are having insurance issues, and even within those counties, the problems are limited largely

to within just a few miles of the coast. In Mississippi, 6 of its 82 counties are directly experiencing problems. Louisiana, which took the brunt of hurricane Katrina, only has experienced troubles in the 24 of its total 62 coastal parishes. These trouble spots are somewhat limited, but they comprise the bulk of the cases we have all heard about on the news, where insurance costs are skyrocketing, building has come to a standstill, and mortgage defaults are on the rise.

In some areas of the country however, the lack of availability and affordability is impacting the entire state—as is the case in Florida and South Carolina. The Florida market has been battered by 8 storms in 2 years resulting in \$38 billion in losses, and the impact spans virtually the entire state. For those living in Florida's high-risk areas, the real tragedy occurred after the storms as policyholders experienced displacement, shortages in building supplies, shortages in homebuilding labor, rising insurance premiums, mortgage defaults, and the unavailability of private insurance. Even today, one can see blue tarps covering homes that have not been repaired fully from the prior hurricane seasons.

Although the voluntary market recapitalized by infusing approximately \$1 billion of new capital into the private market, this situation is not self-sustaining. There are a far greater number of insurance companies exiting the homeowners insurance market than there are new companies entering. Even for those companies staying in the market, there has been a significant retrenchment. Companies are enforcing stricter underwriting standards to limit their exposure in certain high-risk areas or limiting types of property they select to insure.

South Carolina has been at the forefront of regulatory modernization and is considered a model regulatory environment by many insurers. The state also adopted the 2003 International Building Codes and has not had a direct hit from a major hurricane (*e.g.*, Category 3 or better) in nearly two decades. Yet, South Carolina is experiencing many of the same problems that the Gulf Coast states are experiencing. Shortly after Hurricane Katrina, admitted carriers were seeking to increase rates by 100 to 200 percent, decreasing coverage by requiring 5 to 10 percent deductibles, non-renewing long-term policyholders and discontinuing writing new business in certain areas. Surplus lines carriers were increasing rates even more—by as much as 300–400 percent. Condominiums were particularly hard hit as insurers recognized the risk concentration they presented. One development saw its premium increased from \$126,000 to \$879,000 and it took 5 different insurers to piece together the coverage. Many condominium owners in South Carolina are retirees and senior citizens on fixed incomes so, again, this problem is having a disparate impact on a large segment of the population who do not have many options.

South Carolina has implemented many of the measures the insurance industry says need to be in place to create the kind of free-market environment that would enable the private sector to handle this problem, and yet, the state is seeing only scattered relief from the lack of available and affordable property insurance. In South Carolina's coastal counties, the number of policies written by admitted insurers has only increased 3 percent, while population has grown 9 percent, building permit activity has increased 27 percent, and property values have increased 28 percent since 2000. Like other coastal states, South Carolina also has a Wind Pool to pick up policies that the private market won't cover. From 2001 through the third quarter of 2006, the written premiums for the Wind Pool increased 88 percent for residential lines and 448 percent for commercial lines. In the past several months, however, there are indications that the coastal property insurance market may be improving. Insurers are not reporting the same problems acquiring reinsurance as they did in 2006. Other insurers and producers have indicated that capacity within the reinsurance market has increased and that reinsurers are looking at deploying that increased capacity in the coastal property insurance market in South Carolina and other southeastern states. Additionally, the Wind Pool has reported that it is losing some of the condominiums that it insured in 2006. These condominiums are canceling coverage with the Wind Pool because they are finding better coverage and/or better rates elsewhere. Recently, the Wind Pool indicated that it has had some days with negative written premium. All are indications that there is more capacity within the market.

Outside of Florida, those markets are absorbing the impact of recent catastrophic events, but in areas that were hit hardest, insurers are responding as if the next big catastrophe is certain to be a hurricane that hits the exact same region in the Gulf Coast, and pricing coverage accordingly. This begs the question, what happens if the next catastrophe is an earthquake in the Midwest or a massive Nor'easter in New England? Will those policyholders see a doubling and tripling of their rates because insurers are not adequately hedging their risk, and we as a nation are not doing the pre-event building, planning, and mitigation steps that limit those losses? Clearly, people who build and buy homes or operate businesses directly in harms

way, whether that is on a coastline or a fault line, should pay insurance costs that reflect that risk, but they should not be the scapegoats for insurers, reinsurers, risk modelers, regulators, and legislators who fail to learn the lessons of 2004 and 2005.

#### **Financial Health of the Property and Casualty Industry**

Let me first caution that the figures I am providing are preliminary and might change slightly as more information arrives in regulators' offices. Annual financial statements are due March first of each year. There are some insurers who ask for and are granted filing extensions. When the filings are received, they undergo a thorough evaluation with many checks and balances known as "crosschecks" that are applied to assure that the data submitted is complete and as accurate as it can be. This process takes time.

It is safe to say that 2006 was a very good year for the U.S. property and casualty insurance industry. There were no hurricanes that made landfall in 2006 and other catastrophe losses were low. The lack of major catastrophes combined with favorable market pricing conditions led to a record year for insurers. The industry posted an underwriting gain of over \$34 billion and it achieved its lowest combined ratio in years, estimated to be 92.6 percent. The combined ratio is a way to determine if insurers made money on their insurance operations with 100 percent combined ratio being a break-even point. Thus a combined ratio below 100 percent means that the underwriting part of the business was profitable. In addition to making money on underwriting, insurers also make money on their investments. Between underwriting results and investment results, the property and casualty industry's policyholders' surplus grew to almost \$480 billion.

#### **Rate Regulation and Insurer Practices**

You likely will hear from industry representatives that rate regulation causes them to be less competitive than they might be otherwise. They generally refer to rate regulation as price control. This is an inaccurate term. The process in almost all states for virtually all insurance products written by property and casualty insurers starts with the insurance company actuaries preparing a rate change proposal and providing it to insurer management. Management considers the input from their actuaries and from their marketing people and decides whether a rate filing will be submitted and, if so, how much will be charged. The rate filing is then prepared and submitted to the state regulator. In some cases, it must be approved by the regulator, but for many states and many lines of business, it does not. For example, in Arkansas, for personal lines products and small commercial lines products an insurer would file the rates and be able to use them within 20 days as long as the markets are competitive. Prior approval would be required only if I were to find that a particular market is noncompetitive. Insurers who write large commercial risks would not even be required to make a filing.

Insurers often maintain that price controls make them noncompetitive. I think you will agree that the financial performance of the property and casualty industry in recent years makes that statement ring hollow. I expect that some witnesses will agree with these statements and suggest that insurance regulators should do more to lower prices.

Insurance is a cyclical business. In some years, insurers make a decent return and, in other years, competitive forces lead them to lower prices and they lose money. Catastrophes can affect the bottom line. It is a regulators job to balance the competing interests of all parties to the insurance contract. Insolvent insurers do not pay claims so insurance regulators must be sure that insurers are charging adequate rates. Consumers want to pay low prices for quality insurance products. Thus the insurance regulator must assure that rates are not excessive and that the insurance contract delivers reasonable benefits that comply with state laws and regulations. Insurance consumers want their insurers to treat them fairly with regard to price and claim settlement. Thus the insurance commissioner is charged with making sure that rates are not unfairly discriminatory. I say "unfairly discriminatory" because rates are, by nature, discriminatory. Insurers assess the risks that each consumer presents and have a rating system that uses a variety of risk classification factors to determine the price that a person or family will pay. Each state has an Unfair Trade Practices Act and many have Unfair Claim Settlement Practices Regulations that govern insurer conduct in the marketplace.

The invitation letter to this hearing inquires about claims and policy writing practices of insurers. Insurance is a business of contracts. Each insurance policy is a contract between the policyholder and the insurer to perform certain activities if certain unintended events occur. The requirements for the coverage provisions of insurance contracts are based in state law and regulation. It may be that if a state has enacted a law or regulation, it is because some insurer at some time disadvantaged

a policyholder or claimant who complained about the treatment to a state legislator who drafted a law to fix the problem. Thus, not all insurance contract provisions have a law in place that specifies how that contract is to be drafted. Since actions of insurers are local, it is also safe to say that no two states have exactly the same laws on the books.

Recent news events related to the 2004 and 2005 hurricane seasons have shown a spotlight on insurance contracts. The most common problem was consumer dissatisfaction with claim settlements related to whether it was wind or water that caused a particular loss. This problem arose because the coastal consumer cannot go to a single insurer and obtain all of the coverages he or she needs. The National Flood Insurance Program (NFIP) was created in the 1960s because insurers no longer wanted to provide coverage for floods. The storm surge in hurricanes is considered to be a flood by the insurance industry and the NFIP. To be fully covered in a coastal county, a family might need to purchase three separate insurance policies: a homeowners policy from a private insurer that covers all perils except for wind and flood, a wind policy from a state-based Wind Pool and a flood policy from the NFIP. The problem for the consumer arises when there is debate about which of the perils caused a particular loss. In other words, did the wind knock down the house before the storm surge washed all the wreckage away or did the house withstand the wind only to be washed away by the storm surge? When all that remains of the house is a pile of rubble, it is difficult for claims adjusters to determine which peril was responsible for the damages. Having multiple adjusters assessing a single loss only compounds the problem.

A companion problem is the fact that the homeowners policy, the wind policy and the flood policy all have different coverage limits and the details of what is covered differ in each policy. Thus, it is possible for a well-meaning homeowner to try to do the right thing by purchasing three insurance contracts and end up with a shortfall at claim settlement time.

Much has been made of the anti-concurrent cause language in a standard property insurance policy. This provision is a direct result of the bifurcated insurance system we have, and was developed by the insurance industry to protect insurance companies from having to pay for losses (in this case, flood losses) which are excluded from coverage and for which they did not collect a premium. It is a provision that frankly had not been tested at the magnitude of a storm like Hurricane Katrina where wind and water losses were so wide spread. Some have suggested that this provision allows companies to avoid paying their obligations of coverage when flood damage is present. This is *not* the intent of that language, and the vast majority of companies do not distort the provision to shirk their obligations. In Mississippi, for example, where this issue has become the subject of much debate, Commissioner Dale issued a bulletin immediately following Hurricane Katrina to all property and casualty insurers instructing them that the burden of proof for determining the cause of loss is on the insurers, not the policyholders. Furthermore, Commissioner Dale advised companies that when there was doubt as to whether damage was caused directly by flood or wind, the insurers were to err in favor of covering the insured.

Despite this, there have been serious allegations that some companies or adjusters have wrongly denied claims while misconstruing this provision, and they are now being forced to defend that contention to their insurance department or in the courts. The fact that insurers feel compelled to structure their policies to create legal barriers to segregate various perils (with the cost to defend these legal barriers often factored into rates), and those barriers add confusion and uncertainty for policyholder who are now challenging those barriers in courts. It is worth considering a system that offers consumers an all-perils policy that covers wind and water and eliminates the need for this provision along with any possible distortion or manipulation of its intent.

Our role as insurance commissioners is to foster an industry that prepares people before and then provides for them after some of the worst possible events that they may endure in their lifetime. Thank you for taking the time to hold this hearing, for inviting me here today to participate, and for your continued interest and leadership on this crucial issue. I am pleased to answer any questions that you may have.

Senator PRYOR. Great, thank you.  
Mr. Hunter?

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

Mr. HUNTER. Good morning.

I also formerly served as the Federal Insurance Administrator and ran the National Flood Insurance Program under Presidents Ford and Carter, and also as Texas Insurance Commissioner.

In 2004, four hurricanes hit Florida. The property and casualty insurance industry set a record profit. In 2005, Katrina and other hurricanes, another record profit. In 2006, no storms, a third straight record profit. A total, over the 3 years, of \$157.4 billion in profit, which amounts to profit, not premium, \$524 for every American, or \$1,574 per household, in profit.

At the same time, as you've heard, there have been some problems of getting claims paid along the Gulf Coast. And profits are a good thing. A strong industry is necessary. But unjustified profits and excessive capitalization and precipitous acts by insurance companies to stop writing business or drop business or jack up prices—I got a call last night from my daughter, who's price in—5 miles off the coast in Florida, in a very modest home, is now well over \$5,000 a year, and she really can't afford it.

After Hurricane Andrew hit, in 2002, the insurance industry had—said they had a problem, and they wanted to retool. And we all worked on it. I worked with them in Florida, and then later in Texas as Commissioner. They said they needed to sharply cut back coverage through deductibles and other provisions. They said they needed to jack up prices significantly using scientific models. They said they needed State pools to dump high risks. And they got all those things.

They also said—and I know it personally, because I was commissioner, and I also heard it in Florida—they also said that when these three things were done, there would never be any kind of crisis again. That was their promise in order to gain these—and yet, we know today they reneged on that. Now, whether they mismanaged the transition after Hurricane Andrew or are gouging today, I leave it to you to consider which it is, but if you look at the profits, you might think it might be the latter.

Consumers face serious insurance problems outside of the Gulf Coast, as well. Attorney General Spitzer, before he became Governor, of course, found bid-rigging, hidden kickbacks, the largest, most sophisticated insurers in the country—I mean, buyers, rather—the largest, most sophisticated buyers were duped by the insurance companies because of their antitrust exemption and other things. Insurers use identical or similar claims processing systems throughout the country to systematically underpay claims; and yet, State regulation has not done anything about it.

Congress should study these serious issues; and, in doing so, Congress should reject insurance industry proposals that have been introduced, such as the creation of an optional Federal charter, which would, astonishingly, given the weakness of State regulation, actually gut the few protections that are in place. If you're going to move, Congress, please make sure that consumers are protected, not insurance industry protection.

For example, in the wake of Hurricane Katrina along the Gulf Coast, the insurance commissions would have no authority, under

an optional Federal charter-type provision, to actually re-regulate rates or move in and protect consumers.

We urge Congress to reject the anti-consumer proposals. Instead, look for options that would improve competition and oversight of the market. My main message to you is that tough oversight of the market is not incompatible with vigorous competition. The proof is California's auto insurance market. Proposition 103 was passed by the people. It included a total competitive package, which included repeal of the State antitrust exemption, and it also included vigorous regulation. It has the best system of prior approval rate regulation in the Nation, and tended to hold prices down to the—to a reasonable level. It has allowed insurers to realize profits that are slightly above the national average since it was introduced, but the consumers have seen prices drop dramatically. When it passed, California's auto insurance rates were 36 percent higher than the Nation, they were the third highest State in the country. Today, they're the 19th, and their rate is actually below the national average. So, the combination of regulation and competition working together, why not both? They both seek the same goal, they both seek the lowest possible price consistent with a fair return for the insurer. They can work together.

So, immediate steps that Congress should consider are:

One—and this is the most important—repeal the antitrust exemption. And we like S. 618 very much, and we thank Senator Lott and the others who have supported that. We've testified, already, before the Judiciary Committee, about that.

We like the idea of clearer disclosure for the benefit of consumers. And, again, we point to Senator Lott's bill as a good example of what we're talking about, S. 1061.

We'd like to see the FTC freed up to help consumers in the—in these markets, particularly unfair discrimination that we know exists throughout the country. Things like use of consumer's occupation or educational attainment to price insurance is not right.

FTC should also study the unfair claims settlement practices of insurers, particularly the use of computerized systems designed to underpay claims, being used across the industry.

We should look at the questions of title insurance and other things that inappropriately drive up home purchasing costs, and the kickbacks involved there.

Consumer groups do not care who regulates insurance, really. They don't care if it's State or Federal. But we do care that the regulatory system be excellent. We are critical of the current state-based system, but we will not accept a new Federal system that's worse.

Mr. Chairman, it's—it is possible to create a regulatory system, whether it's State or federally based, that protects consumers and forces vigorous industry competition. We think this hearing is a great first step toward those goals.

[The prepared statement of Mr. Hunter follows:]

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

Good morning, Mr. Chairman and members of the Committee. 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. My name is Bob Hunter. I am the Director of Insurance for the Consumer Federation of America. 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, quality that is weak and declining throughout the Nation today. Therefore, your hearing is timely. We especially appreciate the fact that the Committee is beginning its review with an overall examination of insurance regulation—why it exists, what are its successes and failures—rather than solely reviewing proposed legislation. In order to determine whether Federal legislation is necessary and what its focus should be, it obviously makes a great deal of 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 we are very concerned about the quality of consumer protections that are in place, wherever the locus of regulation resides in the future. I will then 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 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 later 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 the 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 at their whim, should a regulator propose rules that they do not like.

I explain why market “competition” alone cannot be relied upon to protect insurance consumers, despite insurer attempts to reduce or eliminate consumer protections. 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) often leads to a 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—euphemistically termed “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.<sup>1</sup>

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 the insurers, including the optional Federal charter approach and the SMART Act, both of which CFA strongly opposes. We do indicate support for S. 618, a bill that would repeal the McCarran-Ferguson Act's broad antitrust exemption that insurers enjoy, to end the collusion in pricing and other market decisions that are legal today. The Senate Judiciary Committee is working on S. 618, which also has broad support from other national consumer organizations.<sup>2</sup>

### **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 reg-

ulation. 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 occurred in the 1990s through to today, state regulators appear to be doing a better job.

*Unfair and Deceptive Policies and Practices:* Insurance policies, unlike most other consumer products or services, are contracts that promise to make certain payments under certain conditions at some point in the future. Consumers can easily research the price, quality and features of a television, but they have very limited ability to do so on insurance policies. Because of the complicated nature of insurance policies, consumers rely on the representations of the seller/agent to a far greater extent than for other products. Regulation exists to prevent competition that fosters the sale of unfair and deceptive policies and claims practices.

Unfortunately, states have not fared at all well in this area. Rather than acting to uncover abuses and instigate enforcement actions, states have often reacted after lawsuits or news stories brought bad practices to light. For example, the common perception among regulators that “fly-by-night” insurance companies were primarily responsible for deceptive and misleading practices was shattered in the late 1980s and early 1990s by widespread allegations of such practices among household names such as 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 by New York Attorney General Eliot Spitzer show that even the most sophisticated consumers of insurance can be duped into paying too much for insurance through bid-rigging, steering, undisclosed kickback commissions to brokers and agents and through other anticompetitive acts. The recent *New York Times* article on long-term care insurance claims abuses are another example of serious problems consumers face in the current weak regulatory climate.<sup>3</sup> The appalling abuses of consumers that occurred in the wake of Hurricane Katrina 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, posted on the website 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 6 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.

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’ website 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 1990s, 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 (PCCP)<sup>4</sup>

There are also adverse implications for consumers in 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).<sup>5</sup> 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.”<sup>6</sup> 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.<sup>7</sup> Other lawsuits have been filed against most of America’s leading insurers for the use of these computerized claims settlement products.<sup>8</sup>

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.

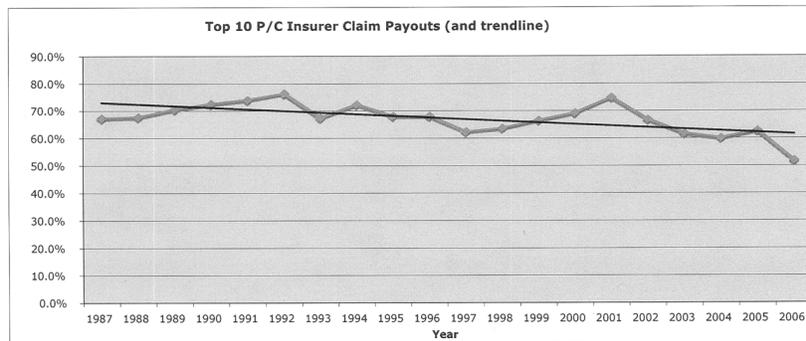
Colossus has been bought by most major insurance companies in response to marketing efforts by CSC promising significant savings. McKinsey & Company has also encouraged several companies to use Colossus.<sup>9</sup> “Before the Allstate launched a project in 1992 (called CCPR—Claims Core Process Redesign), McKinsey named its USAA project ‘PACE’ [Professionalism and Claims Excellence]. At State Farm, McKinsey named its project ‘ACE’ [Advanced Claims Excellence].”<sup>10</sup>

When McKinsey introduced Allstate to Colossus, “McKinsey already knew how Colossus worked having proved it in the field at USAA.”<sup>11</sup> 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.”<sup>12</sup>

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 bad 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.<sup>13</sup>



It is truly inappropriate for property/casualty insurers to be delivering only half of their premium back to policyholders as benefits.<sup>14</sup>

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.<sup>15</sup> Regulation exists to limit destructive selection competition that harms consumers and society.

Lawsuits brought by fair housing groups and the Department of Housing and Urban Development (HUD) 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 cutoff 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.<sup>16</sup> 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?” below.)

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,<sup>17</sup> insurers market their policies to a third party, such as creditors or auto dealers, who, in turn, sell the insurance to consumers on behalf of the insurer for commission and other compensation. This compensation is often not disclosed to the consumer. Absent regulation, reverse competition leads to higher—not lower—prices for consumers because insurers “compete” to offer greater compensation to third party sellers, driving up the price to consumers.

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

The markets for low value life insurance and industrial life insurance are characterized by overpriced and inappropriately sold policies and a lack of competition. This demonstrates the need for standards that ensure substantial policy value and clear disclosure. Insurers rely on consumers’ lack of sophistication to sell these overpriced policies. With some exceptions, states have not enacted standards that ensure value or provide timely, accurate disclosure. Consumers continue to pay far too much for very little coverage.<sup>18</sup>

*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. 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 10 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 10 years ago.
- Insurance is being used by more Americans not just to protect against future risk, but as a tool to finance an increasing share of their future income, *e.g.*, through annuities.
- Increased competition from other financial sectors (such as banking) for the same customers could serve as an incentive for misleading and deceptive practices and market segmentation, leaving some consumers without access to the best policies and rates. If an insurer can't compete on price with a more efficient competitor, one way to keep prices low is by offering weaker policy benefits (*i.e.*, "competition" in the fine print).
- States and lenders still require the purchase of auto and home insurance. Combining insurer and lender functions under one roof, as allowed by the Gramm-Leach-Bliley Act, could increase incentives to sell insurance as an add-on to a loan (perhaps under tie-in pressure)—or to inappropriately fund insurance policies through high-cost loans.
- Insurers are gutting coverage inside of homeowners insurance policies in ways that are difficult for consumers to understand or overcome.<sup>19</sup>

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

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

Consumers 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.<sup>20</sup> 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 data 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 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.

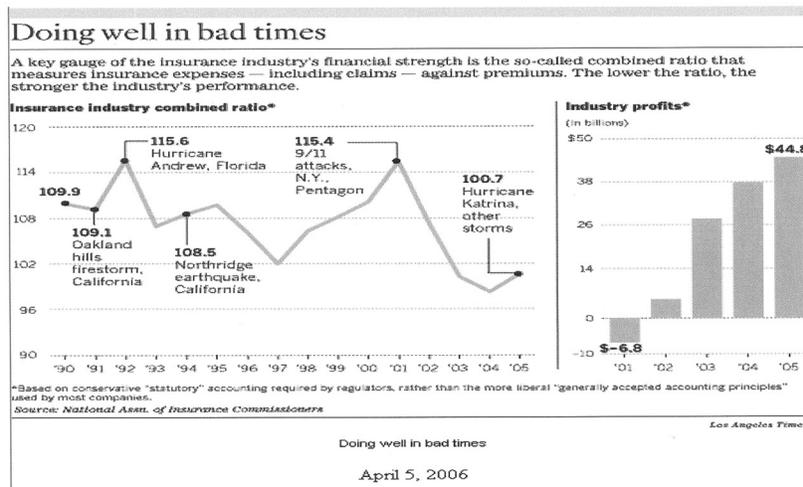
The second essential purpose of insurance is to promote loss prevention. Insurance is the fundamental tool for providing economic incentives for less risky behavior and economic disincentives for more risky behavior. The insurance system is not just about paying claims; it is about reducing the loss of life and property from preventable events. Historically, insurers were at the forefront of loss prevention and loss mitigation. 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.<sup>21</sup>

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,<sup>22</sup> onto states through state catastrophe funds and onto 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. 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 that Covers Less and Less Risk**

In 2004, four major hurricanes hit Florida, but the property-casualty insurance industry enjoyed record profits of \$40.5 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 \$48.8 billion. Here is a chart from a *Los Angeles Times* article on this subject:<sup>23</sup>



Since the article was published, the property-casualty industry has reported the largest annual profit in its history. In 2006, the industry net income was \$68.1 billion.<sup>24</sup> To put this into perspective, the \$157.4 billion in profit over the last 3 years equates to roughly \$524 for every American, or \$1,574 per household.<sup>25</sup>

Some might argue that insurers are risk takers. Although, that may be true for the reinsurance industry,<sup>26</sup> it is certainly not true for the primary market. The primary market has 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 5 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 cutback coverage for many homeowners in coastal areas, it has presented shareholders with very low risk:<sup>27</sup> Beta = 0.90; Financial Safety = 1, and Stock Price Stability = 95.

ValueLine posts results for 26 property/casualty insurers.<sup>28</sup> The simple averages for these carriers are: Beta = 0.97; Financial Safety = 2.4; and Stock Price Stability = 83.

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 (\$40.5 billion) despite the fact that four major hurricanes caused significant damage in Florida. Insurers achieved another record of \$48.8 billion in 2005, despite the unprecedented losses caused by hurricanes Katrina, Rita, and Wilma. In 2006, profits were the highest 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 made 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 year, however, Risk Management Solutions (RMS) and other modelers are moving from a 10,000-year projection to a five-year projection, which will cause 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. This means that the hurricane component of insurance rates will sharply rise, 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 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.<sup>29</sup> 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 after over a decade of using models they assured the public were scientifically sound. RMS has become the vehicle for collusive pricing.

A year 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. Florida, to its credit, did not allow the new model to be used by primary insurers and it appears as if Georgia has not allowed it either. In the meantime, residents in the other 16 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."<sup>30</sup>

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 and 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 these decisions. It is irresponsible to implement before peer review. There are tremendous policy implications.'<sup>31</sup>

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,<sup>32</sup> 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 5 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 percent 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."

To date, the NAIC has been absent on an issue that is vital to millions of Americans who live and work near the Nation's coastlines. As stated above, this regulatory negligence has harmed millions of consumers.

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 5 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. This is the most draconian reduction of all that insurers have attempted to impose in recent years. 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. This is intellectually ambiguous, even if the language creating such an unbelievable attempt to confuse consumers is found to be clear.

At a hearing held by the House Financial Services Oversight Subcommittee on February 28, 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, declaring the wind coverage to be trumped by the flood. Such cases often lead to the payment of full flood coverage, even if all or some of the losses paid by the NFIP 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, non-renewing 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. After Andrew, Allstate threatened to non-renew 300,000 South Floridians, provoking a state moratorium on such action. Today, Allstate is non-renewing even in Long Island and not writing in entire states, like Connecticut. Yes, you heard me right, all of Connecticut, even 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, with the size and intensity surprising them and causing them to make these 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 4 years ago.<sup>33</sup>

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 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,<sup>34</sup> it is well-documented in studies by the Texas and Missouri Departments of Insurance that credit scoring is biased against low income and minority consumers.<sup>35</sup> And recently, GEICO’s use of data about occupation and educational status has garnered the attention of New Jersey legislators.<sup>36</sup> 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 a minimum limits policy 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 attorney generals. State attorney generals charged in court that the last liability insurance crisis was caused in great part by insurers sharply raising their prices to return to 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. 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.<sup>37</sup> 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 5 percent and replicate the old “bureau” rate quite readily.

It is clear that the rate bureaus<sup>38</sup> still have a significant anti-competitive influence on insurance prices in America.

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

- The rate bureaus manipulate historic data in ways that would not be legal absent the McCarran-Ferguson antitrust 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 Ranking Member have introduced S. 618, a bill that would repeal the antitrust exemption and allow the FTC to get involved if the insurers engage in anticompetitive behavior not immunized by the state action doctrine. CFA supports passage of S. 618.<sup>39</sup>

#### 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.

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.<sup>40</sup>

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 fuller 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 February 19 to avoid potential conflicts of interest.”<sup>41</sup>

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

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.<sup>42</sup> 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 interstate 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 exclusive authority for insurance regulation to the states, with no routine Congressional review. The Act also granted insurers a virtually unheard of exemption from antitrust laws, which allowed insurance companies to collude in setting rates and to pursue other anticompetitive practices without fear of Federal prosecution.

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

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

Further, the insurance industry has used the possibility of an increased Federal role to pressure NAIC and the states into gutting consumer protections over the last three or 4 years. Insurers have repeatedly warned states that the only way to preserve their control over insurance regulation is to weaken consumer protections.<sup>43</sup> They have been assisted in this effort by a series of House hearings, which rather than focusing on the need for improved consumer protection have served as a platform for a few Representatives to issue ominous statements calling on the states to further deregulate insurance oversight, “or else.”

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 the way to “save” state regulation is to gut consumer protections to placate insurance companies and encourage them to stay in the fold. This strategy of saving the village by burning it has made state regulation more, not less vulnerable to 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.<sup>44</sup>

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 Ernie 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.

#### *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 2 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.

### **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.<sup>45</sup> We question the entire foundation behind the assumption that virtually no front-end regulation of insurance rates and terms coupled with more back-end (market conduct) regulation is better for consumers. 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 complement 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,<sup>46</sup> 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 2003, the average annual premium in California was \$832.69 (ranked 19th) vs. \$837.88 for the Nation.<sup>47</sup> Since California transitioned from relying simply on competition—as promoted by insurers—to full competition and regulation, the average auto rate went up by 11.3 percent while the national average rose by 51.8 percent—a powerhouse result for California's consumers!<sup>48</sup> In 1989, California consumers were paying 36 percent more than the national average, while today they pay virtually 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*,<sup>49</sup> provides detailed standards that regulators should meet to properly protect consumers, whether at the state, multi-state or national level. It should be noted that none of the proposals offered by insurers or on behalf of insurers 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 13 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 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.

#### *Regulation by Domiciliary States Will Lead to Unacceptably Weak Standards*

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.

### **Current 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 don't 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 3 years of record profits in a row, has led insurers to step back from regulatory “reform” right now. 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. (One of these bills was introduced last year by Senators Johnson and Sununu as S. 2509.) 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 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. 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 also be helpless to stop the misuse of risk classification information, such as credit scores, territorial data and the details of consumers' prior insurance history, for pricing purposes. The draft 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 Bill #3: Non-admitted Insurance/Reinsurance Regulation*

This sharply scaled-back version of the SMART Act would only apply to surplus (non-admitted insurance) lines of insurance and reinsurance. It has been introduced this year by Senators Martinez and Nelson as S. 929. It would provide for a method of collecting state premium taxes for surplus lines and allocating this income to the states. It would give deference to the regulations of the home state of the entity purchasing the insurance policy and in regulating surplus lines brokers. Further, the bill would adopt the NAIC's non-admitted insurance model act for eligibility requirements for surplus lines carriers on a national basis, preempting other state laws. It allows large buyers of insurance to get surplus lines coverage without having to show, as most states require today, that a search of the licensed market was made and no coverage was found.

It would give deference to the home state of the ceding insurer for regulation, prohibiting any state from enforcing extra-territorial authority of its laws. Solvency regulation would be done by the state of domicile of the reinsurer.

CFA opposes this bill because it is based upon many faulty assumptions. First, it assumes that large buyers of insurance are sophisticated enough that they don't need protections that would normally be provided in an insurance transaction. Of course, the investigations and settlements implemented by New York Attorney General Eliot Spitzer mentioned above refute this assumption.

Secondly, the bill assumes that the domiciled state of an insurer is best for solvency regulation. This is not true. As indicated earlier, when I was Insurance Commissioner of Texas, we had to investigate an insolvent insurer in another state because the commissioner of that state refused to do so. We list above several other objections to giving deference to the state of domicile, which are also relevant.

Third, the bill raises concerns about great regulatory confusion and ineptitude that would likely result when the state of the insured entity regulates all parts of that entity's insurance transaction. What does Iowa, for instance, know about the hurricane risk/claims of the operations of an Iowa business on the Gulf Coast or how no-fault or other unique state laws should apply to a given claim situation?

Fourth, the bill would allow consumers to be harmed in the event that a surplus lines insurer becomes insolvent. This is because the guaranty associations in all states do not cover claims for surplus lines insurers. This may be no problem for the defunct policyholder and the defunct insurer, but it sure is a problem for the people that the policyholder may have injured.

*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 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.

*A Pro-Consumer Bill Whose Time has Come: Amending the McCarran-Ferguson Act to Remove the Antitrust Exemption*

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.

*Another Pro-Consumer Bill: Improving Disclosure to Consumers*

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 "Homeowners' 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 Committee to strengthen consumer protections for insurance, Mr. Chairman. I will be happy to respond to questions at the appropriate time.

**Endnotes**

<sup>1</sup> See "Why Not the Best," an analysis of why California has the best regulatory scheme in the Nation at [www.consumerfed.org](http://www.consumerfed.org).

<sup>2</sup> The consumer groups 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.

<sup>3</sup> "Aged, Frail and Denied Care by Their Insurers," March 26, 2007.

<sup>4</sup> "Your Own Worst Enemy, Continued," Blog of Sam Friedman, Editor, National Underwriter Magazine, [www.property-casualty.com](http://www.property-casualty.com), February 21, 2007. Posted on *January 31, 2007 23:06*. The blog has other interesting posts on this subject.

<sup>5</sup> 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.

<sup>6</sup> "From Good Hands to Boxing Gloves—How Allstate Changed Casualty Insurance in America," *Trial Guides*, 2006, Berardinelli, Freeman and DeShaw, pages 131, 133, 135.

<sup>7</sup> Bad Faith Class Actions, Whitten, Reggie, PowerPoint Presentation, November 9, 2006.

<sup>8</sup> *Ibid.*

<sup>9</sup> ". . . Mc Kinsey & Co. has taught Allstate and other insurance companies how to deliver less and less." Berardinelli, Freeman and DeShaw, page 17.

<sup>10</sup> *Ibid.* Page 57.

<sup>11</sup> *Ibid.* Page 132.

<sup>12</sup> *Ibid.*

<sup>13</sup> CFA tested this drop in benefits related to premiums to see if it could be attributed to a drop in investment income. Over the timeframe studied, there was a 3 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, investment income explains only about one-tenth of the drop in benefit payouts to consumers per dollar expended in insurance premium.

<sup>14</sup> Insurers contend that the loss adjustment expense is a benefit to consumers. Obviously, this is a "benefit" that does not go 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.

<sup>15</sup> The industry's reliance on selection competition can have negative impacts on consumers. Insurance is a risk spreading mechanism. Insurance aggregates consumers' premiums into a common fund from which claims are paid. Insurance is a contractual social arrangement, subject to regulation by the states.

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

Competition among insurers should be focused where it has positive effects, *e.g.*, creating efficiencies, lowering overhead. But rather than competing on the basis of the expense and profit components of rates, the industry has relied more on selection competition, which merely pushes claims from insurer to insurer or back on the

person or the state. States have failed to control against the worst ravages of selection competition (e.g. Redlining).

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

<sup>16</sup>“Insurers Set to Squeeze Even Tighter,” *Miami Herald*, May 13, 2006.

<sup>17</sup>Such as credit insurance, title insurance and force-placed insurance.

<sup>18</sup>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](http://www.consumerfed.org/pdfs/Title_Insurance_Testimony042606.pdf).

<sup>19</sup>See the discussion of the anti-concurrent causation clause below.

<sup>20</sup>I was Texas Insurance Commissioner and Federal Insurance Administrator when the Federal Insurance Administration was in HUD and had responsibility for the co-regulation of homeowners insurance in the FAIR Plans, as well as flood and crime insurance duties.

<sup>21</sup>Through such innovations as the creation of Underwriter’s Laboratory.

<sup>22</sup>The National flood Insurance Program has been in place since 1968 because insurers could not price or underwrite the risk. The program has now developed the information for such pricing and underwriting and consideration should be given to returning some of this risk to private insurance control. The Federal program has had excessive subsidies and has been ineffective in mitigating risk as well as the private insurers could do it.

<sup>23</sup>Gosselin, Peter, “Insurers Saw Record Gains in Year of Catastrophic Losses,” *Los Angeles Times*, April 5, 2006.

<sup>24</sup>“Review/Preview,” A.M. Best and Co. January 2007.

<sup>25</sup>U.S. Census Bureau, *Projections of the Number of Households and Families in the United States: 1995 to 2010*.

<sup>26</sup>CFA is still researching that question.

<sup>27</sup>ValueLine, December 22, 2006 edition.

<sup>28</sup>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., 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.

<sup>29</sup>According to the *National Underwriter’s Online Service* on March 23, 2006, “Two other modeling vendors—Boston-based AIR Worldwide and Oakland, Calif.-based Egecat—are also in the process of reworking their hurricane models.”

<sup>30</sup>New Speaker Challenges Insurance Risk Projections, *Tampa Tribune*, 1/10/07.

<sup>31</sup>Ethnicist Questions Insurance Rate Data; *Tampa Tribune*, 1/12/07.

<sup>32</sup>What Happened in 2006? *Contingencies*, March/April 2007.

<sup>33</sup>McQuaid, John; Schleifstein, Mark, “Washing Away,” *New Orleans Times-Picayune*. June 23–27, 2002.

<sup>34</sup>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. It is very likely, therefore, that the study will offer an unreliable description of insurance credit scoring and its alternatives.

<sup>35</sup>“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.

<sup>36</sup>Letter from Consumer Federation of America and NJ CURE to NAIC President Alessandro Iuppa regarding GEICO rating methods and underwriting guidelines, March 14, 2006.

<sup>37</sup>A list of activities of ISO is attached as Attachment 3.

<sup>38</sup>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).

<sup>39</sup>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>.

<sup>40</sup>Reviews of calls to the Americans for Insurance Reform hotline are available at [www.insurance-reform.org](http://www.insurance-reform.org).

<sup>41</sup>“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](http://www.yorkdispatch.com/pennsylvania/ci_5225171?source=sb-google).

<sup>42</sup>Studies over the years show that 50 percent 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.

<sup>43</sup>The clearest attempt to inappropriately pressure the NAIC occurred at their spring 2001 meeting in Nashville. There, speaking on behalf of the entire industry, Paul Mattera of Liberty Mutual Insurance Company told the NAIC that they were losing insurance companies every day to political support for the Federal option and that their huge effort in 2000 to deregulate and speed product approval was too little, too late. He called for an immediate step-up of deregulation and measurable “victories” of deregulation to stem the tide. In a July 9, 2001, *Wall Street Journal* article by Chris Oster, Mattera admitted his intent was to get a “headline or two to get people refocused.” His remarks were so offensive that I went up to several top commissioners immediately afterward and said that Mattera’s speech was the most embarrassing thing he had witnessed in 40 years of attending NAIC meetings. He 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.” So other observers of the NAIC see this pressure as potentially damaging to consumers.

Larry Forrester, President of the National Association of Mutual Insurance Companies (NAMIC), wrote an article in the *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 4 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.

<sup>44</sup>Florida has held hearings on the practice.

<sup>45</sup>If America moves to a “competitive” model, certain steps must first be taken to ensure “true competition” and prevent consumer harm. First, insurance lines must be assessed to determine whether a competitive model, *e.g.*, the alleviation of rate regulation, is even appropriate. This assessment must have as its focus how the market works for consumers. For example, states cannot do away with rate regulation of consumer credit insurance and other types of insurance subject to reverse competition. The need for relative cost information and the complexity of the line/policy are factors that must be considered.

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

- Policies must be transparent: Disclosure, policy form and other laws must create transparent policies. Consumers must be able to comprehend the policy’s

value, coverage, actual costs, including commissions and fees. If consumers cannot adequately compare actual costs and value, and if consumers are not given the best rate for which they qualify, there can be no true competition.

- Policies should be standardized to promote comparison-shopping.
- Antitrust laws must apply.
- Anti-rebate, anti-group and other anti-competitive state laws must be repealed.
- Strong market conduct and enforcement rules must be in place with adequate penalties to serve as an incentive to compete fairly and honestly.
- Consumers must be able to hold companies legally accountable through strong private remedies for losses suffered as a result of company wrongdoing.
- Consumers must have knowledge of and control over flow and access of data about their insurance history through strong privacy rules.
- There must be an independent consumer advocate to review and assess the market, assure the public that the market is workably competitive, and determine if policies are transparent.

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

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.

<sup>46</sup>“Why Not the Best? The Most Effective Auto Insurance Regulation in the Nation,” June 6, 2000; [www.consumerfed.org](http://www.consumerfed.org).

<sup>47</sup>*State Average Expenditures and Premiums for Personal Automobile Insurance in 2001*, NAIC, July 2005.

<sup>48</sup>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).

<sup>49</sup>Attachment 1.

#### ATTACHMENT 1

##### CONSUMER PRINCIPLES AND STANDARDS FOR INSURANCE REGULATION

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

- Meaningful disclosure prior to sale tailored for particular policies and written at the education level of the average consumer sufficient to educate and enable consumers to assess a particular policy and its value should be required for all insurance; it should be standardized by line to facilitate comparison shopping; it should include comparative prices, terms, conditions, limitations, exclusions, loss ratio expected, commissions/fees and information on seller (service and solvency); it should address non-English speaking or ESL populations.
- Insurance departments should identify, based on inquiries and market conduct exams, populations that may need directed education efforts, *e.g.*, seniors, low-income, low education.
- Disclosure should be made appropriate for medium in which product is sold, *e.g.*, in person, by telephone, on-line.
- Loss ratios should be disclosed in such a way that consumers can compare them for similar policies in the market, *e.g.*, a scale based on insurer filings developed by insurance regulators or an independent third party.
- Non-term life insurance policies, *e.g.*, those that build cash values, should include rate of return disclosure. This would provide consumers with a tool, analogous to the APR required in loan contracts, with which they could compare competing cash value policies. It would also help them in deciding whether to buy cash value policies.
- A free look period should be required; with meaningful state guidelines to assess the appropriateness of a policy and value based on standards the state creates from data for similar policies.

- Comparative data on insurers' complaint records, length of time to settle claims by size of claim, solvency information, and coverage ratings (*e.g.*, policies should be ranked based on actuarial value so a consumer knows if comparing apples to apples) should be available to the public.
- Significant changes at renewal must be clearly presented as warnings to consumers, *e.g.*, changes in deductibles for wind loss.
- Information on claims policy and filing process should be readily available to all consumers and included in policy information.
- Sellers should determine and consumers should be informed of whether insurance coverage replaces or supplements already existing coverage to protect against over-insuring, *e.g.*, life and credit.
- Consumer Bill of Rights, tailored for each line, should accompany every policy.
- Consumer feedback to the insurance department should be sought after every transaction (*e.g.*, after policy sale, renewal, termination, claim denial). The insurer should give the consumer notice of feedback procedure at the end of the transaction, *e.g.*, form on-line or toll-free telephone number.

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

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

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

- Where coverage is mandated by the state or required as part of another transaction/purchase by the private market (*e.g.*, mortgage), regulatory intervention is appropriate to assure reasonable affordability and guarantee availability.
- Market reforms in the area of health insurance should include guaranteed issue and community rating and, where needed, subsidies to assure healthcare is affordable for all.
- Information sufficient to allow public determination of unfair discrimination must be available. Geo-code data, rating classifications and underwriting guidelines, for example, should be reported to regulatory authorities for review and made public.
- Regulatory entities should conduct ongoing, aggressive market conduct reviews to assess whether unfair discrimination is present and to punish and remedy it if found, *e.g.*, redlining reviews (analysis of market shares by census tracts or zip codes, analysis of questionable rating criteria such as credit rating), reviews of pricing methods, and reviews of all forms of underwriting instructions, including oral instructions to producers.
- Insurance companies should be required to invest in communities and market and sell policies to prevent or remedy availability problems in communities.
- Clear anti-discrimination standards must be enforced so that underwriting and pricing are not unfairly discriminatory. Prohibited criteria should include race, national origin, gender, marital status, sexual preference, income, language, religion, credit history, domestic violence, and, as feasible, age and disabilities. Underwriting and rating classes should be demonstrably related to risk and

backed by a public, credible statistical analysis that proves the risk-related result.

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

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

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

- Personal financial information should not be disclosed for purposes other than the one for which it is given unless the consumer provides prior written or other form of verifiable consent.
- Consumers should have access to the information held by the insurance company to make sure it is timely, accurate and complete. They should be periodically notified how they can obtain such information and how to correct errors.
- Consumers should not be denied policies or services because they refuse to share information (unless information is needed to complete the transaction).
- Consumers should have meaningful and timely notice of the company's privacy policy and their rights and how the company plans to use, collect and or disclose information about the consumer.
- Insurance companies should have a clear set of standards for maintaining the security of information and have methods to ensure compliance.
- Health information is particularly sensitive and, in addition to a strong opt-in, requires particularly tight control and use only by persons who need to see the information for the purpose for which the consumer has agreed to the sharing of the data.
- Protections should not be denied to beneficiaries and claimants because a policy is purchased by a commercial entity rather than by an individual (*e.g.*, a worker should get privacy protection under workers' compensation).

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

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

- There should be an independent agency that has as its mission to investigate and enforce deceptive and fraudulent practices by insurers, *e.g.*, the reauthorization of FTC.

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

- Insurance regulators must have a clear mission statement that includes as a primary goal the protection of consumers:
- The mission statement must declare basic fundamentals by line of insurance (such as whether the state relies on rate regulation or competition for pricing). Whichever approach is used, the statement must explain how it is accomplished. For instance, if competition is used, the state must post the review of competition (*e.g.*, market shares, concentration by zone, etc.) to show that the market for the line is workably competitive, apply anti-trust laws, allow groups to form for the sole purpose of buying insurance, allow rebates so agents will compete, assure that price information is available from an independent source, etc. If regulation is used, the process must be described, including access to proposed rates and other proposals for the public, intervention opportunities, etc.
- Consumer bills of rights should be crafted for each line of insurance and consumers should have easily accessible information about their rights.
- Regulators should focus on online monitoring and certification to protect against fraudulent companies.
- A department or division within the regulatory body should be established for education and outreach to consumers, including providing:
  - Interactive websites to collect from and disseminate information to consumers, including information about complaints, complaint ratios and consumer rights with regard to policies and claims.
  - Access to information sources should be user friendly.
  - Counseling services to assist consumers, *e.g.*, with health insurance purchases, claims, etc. where needed should be established.
- Consumers should have access to a national, publicly available database on complaints against companies/sellers, *i.e.*, the NAIC database. NAIC is implementing this.)
- To promote efficiency, centralized electronic filing and use of centralized filing data for information on rates for organizations making rate information available to consumers, *e.g.*, help develop the information brokering business.
- Regulatory system should be subject to sunshine laws that require all regulatory actions to take place in public unless clearly warranted and specified criteria apply. Any insurer claim of trade secret status of data supplied to the regulatory entity must be subject to judicial review with the burden of proof on the insurer.
- Strong conflict of interest, code of ethics and anti-revolving door statutes are essential to protect the public.
- Election of insurance commissioners must be accompanied by a prohibition against industry financial support in such elections.
- Adequate and enforceable standards for training and education of sellers should be in place.
- The regulatory role should in no way, directly or indirectly, be delegated to the industry or its organizations.
- The guaranty fund system should be 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 reg-

ulatory jurisdiction is at issue. This should be stated mission/goal of recent changes brought about by GLB law.

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

- A national system of “Consumer Alerts” should be established by the regulators, *e.g.*, companies directed to inform consumers of significant trends of abuse such as race-based rates or life insurance churning.
  - Market conduct exams should have standards that ensure compliance with consumer protection laws and be responsive to consumer complaints; exam standards should include agent licensing, training and sales/replacement activity; companies should be held responsible for training agents and monitoring agents with ultimate review/authority with the regulator. Market conduct standards should be part of an accreditation process.
  - The regulatory structure must ensure accountability to the public it serves. For example, if consumers in state X have been harmed by an entity that is regulated by state Y, consumers would not be able to hold their regulators/legislators accountable to their needs and interests. To help ensure accountability, a national consumer advocate office with the ability to represent consumers before each insurance department is needed when national approaches to insurance regulation or “one-stop” approval processes are implemented.
  - Insurance regulator should have standards in place to ensure mergers and acquisitions by insurance companies of other insurers or financial firms, or changes in the status of insurance companies (*e.g.*, demutualization, non-profit to for-profit), meet the needs of consumers and communities.
  - Penalties for violations must be updated to ensure they serve as incentives against violating consumer protections and should be indexed to inflation.
8. *Consumers should be adequately represented in the regulatory process.*
- Consumers should have representation before regulatory entities that is independent, external to regulatory structure and should be empowered to represent consumers before any administrative or legislative bodies. To the extent that there is national treatment of companies, a national partnership, or “one-stop” approval, there must be a national consumer advocate’s office created to represent the consumers of all states before the national treatment state, the one-stop state or any other approving entity.
  - Insurance departments should support public counsel or other external, independent consumer representation mechanisms before legislative, regulatory and NAIC bodies.
  - Regulatory entities should have a well-established structure for ongoing dialogue with and meaningful input from consumers in the state, *e.g.*, a consumer advisory committee. This is particularly true to ensure that the needs of certain populations in the state and the needs of changing technology are met.

#### ATTACHMENT 2

##### *Why Insurance Is an Essential Public Good, Not Some Normal Product That Can Be Regulated Solely Through Competition*

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

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

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

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

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

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

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

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

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

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

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

#### 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.

Senator PRYOR. Thank you.  
Mr. Regan?

**STATEMENT OF DAVID W. REGAN, VICE PRESIDENT,  
LEGISLATIVE AFFAIRS, NATIONAL AUTOMOBILE  
DEALERS ASSOCIATION**

Mr. REGAN. Thank you, Mr. Chairman and Members of the Committee.

I’m David Regan, Vice President of Legislative Affairs for the National Automobile Dealers Association. Our members sell and service all makes—international nameplate, domestic nameplate, from the Mini Cooper to the Mack Truck. Also, last year we sold 20 million used vehicles. So, our members have a direct interest in the integrity of the titling process and the availability of reliable VIN-based vehicle history data.

Each year, thousands of wrecked, flooded, and stolen vehicles are sold with clean titles to unsuspecting consumers. Fraudulent resellers thrive, for three reasons. One, the 51 jurisdiction State motor vehicle titling regime is confusing, contradictory, and incomplete. Two, just because an insurance company declares a total loss does not always mean that the insurance company has to obtain a new title reflecting that severe damage. And, three, there is no public database for total-loss vehicles, and dealers and consumers do not have enough timely access to DMV title data.

Last year, the insurance companies totaled approximately 5 million vehicles. Unfortunately, the total-loss vehicle sold today at salvage auction could be tomorrow’s raw material for the fraudulent rebuilder and title-washer. The confusing State title laws and the loss mitigation model of the insurance companies work in tandem to the detriment of consumers.

There’s one central economic fact about the loss mitigation model of the insurance companies. The cleaner the title at salvage auction, the higher the sales price for a totaled vehicle. Therefore, the insurance companies have a powerful short-term economic incentive to oppose more aggressive State titling laws, and to under-report under existing State titling laws. However, consumers and dealers have exactly the opposite economic interest. Before making a purchase, they want to know if a vehicle has ever been declared a total loss. Unfortunately, if the insurance company fails to report

the total loss to the DMV and obtain a branded title, no public document may ever exist to put future purchasers on notice that the car was declared a total loss. This failure to report shifts the risk of nondisclosure to subsequent purchasers.

To remedy this lack of disclosure, Congress—NADA believes that Congress should enact S. 545, which would require insurance companies to make commercially available the following information: the VIN of the total-loss vehicle; the date of the declaration of total loss; the odometer reading of the vehicle on the date of total loss; a simple reason for total loss, such as flood, salvage, or stolen and recovered; and whether or not the airbag deployed as a result of the event triggering the declaration of total loss. This disclosure would be made when the insurance company sends a loss payoff to the insured. Please note that none of this VIN-based data would trigger any privacy concerns under Federal or State law.

Also, it is our understanding that this new Federal disclosure requirement would not pre-empt State laws, but simply would complement the disclosure regime under existing State title branding statutes.

There is precedent for such a system. In the U.K. and in Australia, insurance companies already provide total-loss data. Also, here in the United States the NICB provided, for the first time, some total-loss data when vehicles were flooded in the 2005 hurricanes. NADA applauds the efforts of the NICB in this regard. But if it is in the public interest to post the VINs of hundreds of thousands of Katrina cars, isn't it also in the public interest to post the VINs of the millions of vehicles that are totaled every year because of severe accidents?

Also, Congress should ask some questions of the insurance companies to determine the extent to which they share total-loss data among themselves. For example, if insurance company A totals a car, and the wrecked car is then purchased at salvage auction, repaired and resold with a clean title to an unsuspecting consumer, what happens when that consumer tries to insure the vehicle that they have just purchased? Can insurance company B access some industry database to determine if the vehicle has been declared a total loss? If so, can insurance company B then use that information to refuse to write coverage or to charge a higher premium to reflect the higher risk of the rebuilt vehicle? If so, will the insurance company then inform the consumer that that car is actually a rebuilt wreck rather than an undamaged vehicle? These are the type of questions that we would like to see asked and answered in the context of congressional oversight about this issue of total-loss disclosure.

In conclusion, before buying a used vehicle, consumers, businesses, and dealers want to know one thing: Has the car ever been declared a total loss? The declaration of a total loss is the most significant event in the economic life of a motor vehicle. That should be—that information should be publicly available prior to any purchase. Using today's technology and the existing databases of the insurance companies, this disclosure is possible. We volunteer to work with any and all interested parties to make public access to total-loss data a reality.

Thank you for your interest in this issue, and we'll be happy to take your questions.

[The prepared statement of Mr. Regan follows:]

PREPARED STATEMENT OF DAVID W. REGAN, VICE PRESIDENT, LEGISLATIVE AFFAIRS,  
NATIONAL AUTOMOBILE DEALERS ASSOCIATION

**More Complete and Timely Total Loss Data Are Necessary To Combat Title Fraud**

My name is David Regan. I am Vice President of Legislative Affairs for the National Automobile Dealers Association. NADA's 20,000 franchised auto and truck dealerships sell, service and repair new and used car and trucks, all makes and models from the Mini Cooper to the Mack Truck. NADA's membership penetration is 93 percent of all domestic and international nameplate dealerships. The majority of NADA's members are small, family-owned and community-based businesses, and NADA's members employ more than one million people nationwide.

*Overview of the Title Fraud Problem*

At NADA, we applaud the members of this Committee and Senator Lott in particular for focusing on such an important national issue. According to news accounts, flooding caused by the Gulf Coast hurricanes in 2005 damaged more than 500,000 vehicles. Unfortunately, many of these severely damaged vehicles have been reconditioned and sold to unsuspecting buyers. In an effort to put consumers on notice of the nature of the problem, NADA's website ([www.nada.org](http://www.nada.org)) contains tips on how to spot a flood vehicle. However, increased public awareness is only a part of the solution.

This problem is *not* limited to "Katrina cars." Flooding in New England and North Carolina and other areas of the Nation has led to countless other flood vehicles. Moreover, cars severely damaged in accidents are a major part of the title fraud problem as well. If an insurance company deems a car to be "totaled" as a result of collision, theft, or fire damage, the vehicle might be rebuilt and given a clean title that does not disclose damage. Last year, we believe that insurance companies totaled approximately five million vehicles.

*Each year thousands of totaled vehicles are fraudulently sold to unsuspecting buyers as undamaged vehicles.* These vehicles may then surface in the classified section of your local newspaper, at a wholesale auto auction, in a consumer-to-consumer sale, or as a "trade in" on the lot of a franchised dealer. The fraudulent rebuilders and resellers enjoy substantial profit margins because: (1) state motor vehicle titling laws are confusing, contradictory and incomplete; (2) insurance companies have a short-term economic interest in under-reporting total loss vehicle data; and (3) the public and private sectors have failed to exploit existing technology to produce timely electronic transparency for motor vehicle title histories.

Today, I will outline how confusing state title laws and insurance company practices benefit fraudulent rebuilders and resellers and how S. 545 could help remedy this problem.

**Disparities in State Titling Laws Create Opportunities for Fraud**

*The laws of fifty states and the District of Columbia govern the titling and registration of motor vehicles, creating a systemic lack of uniformity.* A motor vehicle title documents ownership of a specific vehicle, whereas a motor vehicle registration provides permission to operate a specific vehicle. Although the trend in state titling laws has been toward more uniformity during the past several years, the 51 jurisdictions still conduct business 51 different ways. Each jurisdiction has created a distinct paper title, different computer programs to issue and track titles and registration, and a separate, extensive body of statutes and regulations to govern the titling and registration of motor vehicles within their respective borders. Additionally, these discrepancies can be complicated by the informal policies and procedures used by title clerks, which may vary even within jurisdictions.

*In common usage, a "title brand" is a notation on the face of a certificate of title that provides notice to all subsequent purchasers of the damage, condition, or prior use of a vehicle.* A "brand" is a word, symbol or abbreviation printed on the title itself. The 51 titling jurisdictions use a wide variety of brands, such as reconstructed, salvage, rebuilt salvage, rebuilt, restored, reconditioned, junk, non-repairable, taxi, police, flood damage, fire damage, unsafe, and repaired. The complete list is extensive and confusing.

*Because 51 jurisdictions title vehicles 51 different ways, many opportunities for fraud exist.* Under the current system, any unscrupulous rebuilder can repair or re-

furbish a wrecked or flood damaged car (typically a late model car “totaled” by an insurance company) and then obtain a “clean” or “washed” title in a state with weak title disclosure rules. The new title will contain no reference to the damage, leaving the buyer (consumer, wholesale auction or retail dealer) to rely on a physical inspection of the vehicle that may not expose the extent of the damage or rely on commercially available title history products, such as Auto Check and CARFAX.

*The vehicle history products in the market today are helpful, but a clean vehicle history report is **not** conclusive evidence that a vehicle has never sustained significant damage.* Vehicle history services can only report information to which they have access. While title history products have improved in the past few years, the 2005 settlement between State Farm Insurance and the state Attorneys General demonstrates the extent to which the title data within a state department of motor vehicles is incomplete. Many state titling laws do not require insurance companies to obtain a salvage title for every totaled vehicle. Moreover, the insurance companies have a powerful economic incentive not to obtain a salvage title. Insurance companies receive higher sale prices for these totaled vehicles at salvage auctions if the titles are not branded. As a result, DMV title databases do not include all totaled vehicles.

### **Insurance Company Procedures Exacerbate the Problem**

*Every year millions of motor vehicles are “totaled” by insurance companies, and many of these vehicles routinely re-enter used car commerce.* Typically, an insurance company “totals” a vehicle when the projected repair costs are too excessive in relation to the fair market value of the vehicle immediately prior to the flood or accident. Once the insurance company has totaled a car, the company usually sends a check to the insured, takes possession of the vehicle, and sells the damaged vehicle at a salvage auction to mitigate loss. Unfortunately, fraudulent rebuilders frequently buy totaled vehicles at salvage auction, repair them, and sell the cars as undamaged to an unsuspecting buyer, thereby reaping huge profits.

*The current loss mitigation model used by insurance companies increases the likelihood of subsequent fraudulent activity.* The attached chart (“How Total Loss Vehicles Reenter the Market”) and explanatory material attempts to present the interrelationship between the state titling laws and the loss mitigation model of the insurance companies. While this process may vary from state to state and from insurance company to insurance company, the graphic depicts the lack of transparency that increases risk to subsequent buyers. The red flags indicate the points in the process where fraudulent activity may occur.

*If the insurance company fails to obtain a salvage title for the totaled vehicle, no public document may **ever** exist to put future purchasers on notice that the car was totaled.* The insurance company may fail to report the status of the vehicle to the DMV because:

- (a) The state titling law may not trigger an obligation by the insurance company or the original owner to report to the DMV; or
- (b) State law may contain a reporting obligation, but the insurance company may fail to comply because of administrative oversight.

The settlement between State Farm and 49 state attorneys general confirms that this is not a hypothetical problem.

*Insurance companies have a powerful economic incentive to oppose more aggressive title laws or to underreport under existing laws.* A total loss vehicle with a clean title is likely to sell at auction for substantially more than the same vehicle with a salvage or flood title. In other words, there is a market-based premium for a clean title and a market-based penalty for a salvage or flood title.

*Consumers have exactly the opposite economic interest—they want to know if a vehicle has been declared a total loss.* The decision to total a vehicle is based on a variety of factors and may vary from company to company and from insured to insured, but one fact is abundantly clear—a declaration of total loss is one of the most material factors in determining the value of a vehicle. Every subsequent purchaser would want to know—prior to the sale—if a vehicle has been totaled.

### **The Solution must Focus on Pre-transaction Transparency: Insurance Data on Total Loss Vehicles Should Be Released to the Public and DMV Data Should Be Enhanced and Released More Quickly**

*The type of disclosure advocated in S. 545 is consistent with the Federal and state privacy laws that strictly limit the use of personal information obtained in the titling process.* The Federal Driver Privacy Protection Act and similar state statutes limit the distribution of names and addresses included in title databases. The distribution

of VIN-based title branding data or VIN-based total loss vehicle data would *not* include the personal identifiers protected by those statutes.

*More transparency, more timeliness, and more technology are necessary to provide buyers more complete and reliable VIN-specific data before a purchase.* All buyers of a used vehicle (consumers, businesses, wholesale auctions, and even automobile dealers taking a vehicle in trade) have the same economic interest—determining fair market value *prior to purchase*. A more complete, near real-time title history would provide a more accurate picture of a vehicle's prior condition/use. The insurance companies should be commended for providing some total loss vehicle data for many of the flood vehicles from the hurricanes. The VINs for some of these vehicles are now available on the website of the National Insurance Crime Bureau, but more should be done. One good example of this is PEMCO Insurance in Washington state, which voluntarily disclosed total losses due to heavy storms in November 2006. S. 545 would require the disclosure of the following total loss data: the VIN of a totaled car; the reason for the total loss (flood, collision, stolen, etc.); the date of total loss; the odometer reading on that date; and whether or not the airbag deployed. Armed with total-loss information, consumers, businesses, dealers, auto auctions—anyone buying used cars—should be able to easily identify one of these severely damaged vehicles, even if the title was washed.

We understand that this legislation would NOT pre-empt state motor vehicle titling laws, but would create a separate data set that could be used to complement title data held by DMVs.

*Comments about the National Motor Vehicle Title Information System (NMVTIS)*

*Congress has recognized that technology should play a critical role in this arena.* The Anti-Car Theft Act of 1992 authorized the creation of NMVTIS. As envisioned, NMVTIS would become the single source for title history data from all 51 jurisdictions. The American Association of Motor Vehicle Administrators (AAMVA) has attempted to link all 51 databases in real-time using a combination of Federal funds, state funds, and internal resources. The system envisioned would provide real-time, title clerk-to-title clerk linkage and then provide third party access to title histories. NMVTIS has not been completed because state resources are required to reconfigure state DMV systems to communicate with NMVTIS. AAMVA's attempts to design and implement a system to provide public access to NMVTIS have not been successful.

*NMVTIS should be reconfigured to focus on providing consumers transparency prior to a transaction.* The vast majority of the resources of NMVTIS have been used in an attempt to link DMVs so that title clerks can talk to title clerks electronically before issuing new titles. *Unfortunately, most title fraud occurs before a title clerk ever sees an application for a new title.* DMVs document motor vehicle ownership after a transaction has occurred. Moreover, DMVs do not have the statutory authority, expertise, or financial resources to package and market VIN history data to the public.

*NADA has also expressed concerns to the AAMVA leadership regarding the existing economic model for NMVTIS.* First, additional Federal funding is not likely, so completion of the system is highly doubtful absent an additional source of funding. Second, even if additional public funding were forthcoming we have serious doubts the current model would be self-sustaining. Third, the private sector still does not have access to the title data in NMVTIS, despite the 1992 Anti Car Theft Act requirement granting such access. As a result, we have stated on numerous occasions publicly and privately, that NMVTIS must be redesigned to achieve its original purpose.

*NADA believes the best solution is a partnership between AAMVA and a private sector vendor that has the funding and technological expertise to build upon the existing NMVTIS system.* Private sector information vendors are essential to the distribution of data to consumers. Any NMVTIS-based solution must rely on the private sector to package and market title histories to the general public. These vendors already buy title data from DMVs in bulk, usually every month. If the states simply provided daily electronic updates instead of monthly, the private sector could use technology to close the window for fraud. The end result would be an efficiently administered, up-to-date system that would provide consumers with more timely information. The very same technology could be used to provide title clerk to title clerk access as well.

*Congress should require the Department of Justice to implement the 1992 Anti-Car Theft Act to require insurance companies to disclose total loss data and salvage auctions to disclose sales data.* DOJ has existing statutory authority to create more motor vehicle title transparency in a matter of months. 49 U.S.C. §§ 30501–30505. Congress should compel DOJ to initiate the rulemaking that was originally intended and enforce the penalties under existing law for failing to submit data to NMVTIS.

The rule should: (1) recognize that NMVTIS has been created; (2) require insurance companies to submit to NMVTIS VIN-based information on total loss vehicles; (3) require salvage auctions and junk yards to submit to NMVTIS VIN-based information for vehicles sold at salvage auctions and junk yards; (4) require NMVTIS to engage a private sector joint venture partner to market the NMVTIS data to consumers no later than December 31, 2007; and (5) encourage state DMVs to submit VIN-based motor vehicle title and registration data to NMVTIS in electronic batch form every 24 hours. All data marketed to the public must comply with Federal and state privacy protection statutes.

*NADA believes S. 545 to require insurance companies to make total loss data available to perspective purchasers would complement a newly configured NMVTIS with AAMVA working with the private sector to more aggressively enhance consumer access to title history data.*

#### *Conclusion*

*Any solution to the title fraud problem must be viewed through the pre-transaction lens.* The technological solution to the problem of flood vehicles—and all other title fraud—lies in creating near real-time, pre-transaction access to the vehicle history data that DMVs, insurance companies, and salvage yards currently collect. The enactment of S. 545 would provide a dramatic step in the drive to provide consumers more pre-transaction transparency.

NADA and the franchised automobile and truck dealers throughout the country are prepared to assist with efforts to eliminate title fraud. Thank you for the opportunity to present our views, and I look forward to your questions.

#### EXHIBIT A: HOW TOTAL LOSS VEHICLES REENTER THE MARKET

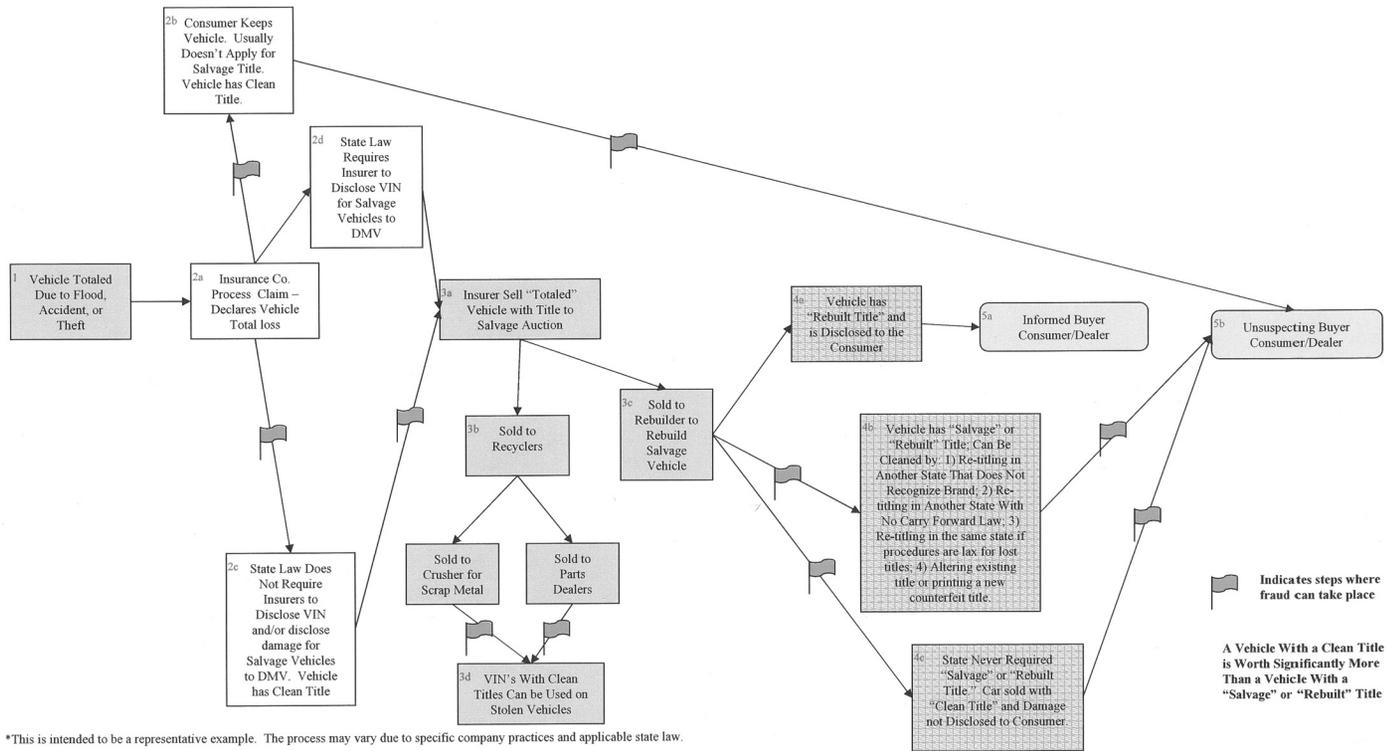
*Box 1.* The process begins when an insurance company declares a total loss on a vehicle.

*Boxes 2a–2d.* In step 2, the insurance company determines if the nature and extent of the damage requires the insurance company to obtain a salvage or flood title under state law. (The fact that the insurance company declares a total loss does *not* automatically trigger an obligation under state laws to obtain a salvage title. Each state has specific statutory and regulatory requirements that control this process.) Under 2a, the insurance company permits the consumer to retain the vehicle after receiving a total loss payment. This creates a red flag because the original owner could repair and resell without disclosure to the unsuspecting buyer in box 5b. In 2b, the company obtains a salvage title, so that title should accompany the vehicle throughout the process and surface in the title history search based on DMV records. However, when the insurance company does NOT obtain a salvage title, as in 2c, the red flag is noted because the vehicle will go to the salvage auction with a clean title, despite having been declared a total loss.

*Boxes 3a–3d.* Step 3 captures the representative transactions at a salvage auction. Reputable buyers at salvage auctions, the recyclers in box 3b, purchase the totaled cars for scrap or parts. The potential for fraud still exists, however, as shown in box 3d. Unscrupulous resellers will purchase the wrecked vehicle solely to obtain a VIN with a clean title. They will then switch that VIN with a stolen vehicle of the same make and model. In some instances, criminals will walk a salvage yard just to collect VINs. If the VINs have “clean” vehicle history reports, the criminals will steal the same make, model, and year, and simply switch the VIN with a clean VIN plate. Box 3c depicts the rebuilders (legitimate and fraudulent) purchasing vehicles at salvage auction.

*Box 4.* This step shows that legal and illegal activity may occur after the vehicle is rebuilt. In box 4a the legitimate rebuilder obtains the necessary title documents and fully discloses the nature of the damage when selling to the informed consumer in box 5a. However, in boxes 4a and 4b no such disclosure occurs so a red flag is noted. In 4b, even if the rebuilder received a salvage title at auction, the fraudulent rebuilder simply washes the salvage title by obtain a clean title in another state. Then the fraudulent reseller unloads the damaged car to the unsuspecting consumer in box 5b without disclosure. The consumer may obtain a title history report, but the data in the private sector database may not be current enough to assist the consumer before the purchase. Similarly, a licensed dealer may not have access to title data prior to a trade-in. In box 4c, the fraudulent reseller does not even have to wash the title, because the insurance company never notified the DMV of the total loss. Moreover, the unsuspecting consumer can find no protection at all in relying on a title history because the insurance company has never provided the DMV any information about the total loss.

## How Total Loss Vehicles Reenter the Market



\*This is intended to be a representative example. The process may vary due to specific company practices and applicable state law.  
 April 9<sup>th</sup>, 2007 JCA

April 11, 2007

To: Members of the Senate Commerce Committee  
 From: Salvage Auto Fraud Reform Coalition (SAFR)

In 2005, over five million vehicles were “totaled” by insurance companies, including over 500,000 from Hurricanes Katrina and Rita. Unfortunately, thousands of these wrecked, flooded, or stolen vehicles are sold with clean titles to unsuspecting consumers each year. *We, the undersigned, who represent millions of U.S. workers, believe legislation is necessary to require that insurers make total-loss data available to the public, thereby “red-flagging” the vehicle forever, and putting consumers on notice of a vehicle’s serious damage history.*

Too often totaled cars are rebuilt and returned to the marketplace—but without a “red flag” to alert consumers. Many of these totaled vehicles are dangerous, yet insurance companies are not required to make the VINs public. Clearly, the most direct and effective method to provide consumers with more complete vehicle histories is for insurance companies to make the VINs of totaled vehicles available to the public.

Insurance companies already collect total-loss disclosure information, however, they do not provide this valuable information to consumers. The disclosure of total-loss data would be VIN-based and would not include any personal identifiers protected by Federal and state privacy laws. Consumers could obtain this total-loss information easily and quickly through existing vehicle history providers.

Last year Congress examined the problem of title washing and title fraud to protect consumers from unknowingly purchasing flood and salvage vehicles. Hearings were held on the issue, and total-loss disclosure legislation was introduced in the Senate and House. Once again, legislation has been introduced in the 110th Congress in both the Senate (S. 545) by Senator Trent Lott, R-Miss., and the House (H.R. 1029) by Representative Cliff Stearns, R-Fla.

Passage of total-loss disclosure legislation would provide used car buyers an important tool for making better decisions about vehicle safety and fair market value. We respectfully urge you to support committee consideration of this important safety and consumer protection legislation early this session.

Sincerely,

National Automobile Dealers Association	Experian
Alliance of Automobile Manufacturers	Honda
American International Automobile Dealers Association	Hyundai Motor America
Association of International Automobile Manufacturers	Mazda North American Operations
Automotive Recyclers Association	National Auto Auction Association
Automotive Service Association	National Independent Automobile Dealers Association
	Volkswagen of America, Inc.

Senator PRYOR. Thank you very much.

I want to thank all the panelists for their opening statements.

Let me start, if I may, with Commissioner Bowman. You mentioned some catastrophic risks in the State of Arkansas. I think you mentioned earthquakes, tornados, hailstorms, and I guess ice storms and floods. So, I assume, from your statement there, it’s fair to say that these catastrophic challenges with insurance are not limited just to the Gulf Coast area. All over the country, you have chances of catastrophic losses. Is that fair to say?

Ms. BOWMAN. That’s exactly right. All States are concerned about the different catastrophic possibilities. All States—I think, looking over all the States, except maybe one—I think North Dakota has, probably, fewer catastrophic possibilities than the other States, but they all have some sort of catastrophe possibility.

Senator PRYOR. Can you just give us a—maybe a one minute tutorial on rates, how rates are set? For example, if there’s a hurricane on the Gulf Coast, does it cause rates in Arkansas to increase? Or if there’s an earthquake on the West Coast, will it cause the rates in Maine to increase? Could you tell us how the rate structure works?

Ms. BOWMAN. No, they should not. They are—it's state-by-state, basically. The—for instance, your constituents in Arkansas should not be paying for the—through their policy, should not be paying for the catastrophes on the Gulf Coast for what they had. The rates would be set based on the losses or the—not the losses, but the future projections for what the model might be in Arkansas. For instance, they're going to look at what—they're going to look at what the history has been, and what they project the future might be, in Arkansas, for projected losses for the catastrophes in Arkansas specifically.

Senator PRYOR. When you say—

Ms. BOWMAN. They would not pay for the Gulf Coast. They would not take that into account.

Senator PRYOR. When you say they “should not,” or they “would not,” in your experience do they take that into account, though?

Ms. BOWMAN. No, we are looking at that. Each insurance department looks into that. When the rates are filed, we look at that and make sure that that's not taken into account. We look at each rate—each time that a rate is filed, we look at three things, and all the departments do this. We make sure that when the rate is filed it is not inadequate, it is not unfairly discriminatory—because rates themselves are discriminatory—and it is not too high. You're not looking to make—you're making sure that the rate is appropriate and that it is fair.

Senator PRYOR. And you also review the policies in the State. For example, what the attorney general was talking about a few moments ago—and the term he used was “anti-concurrent causation”—not just you, but the States, the State insurance commissioners and departments, they look at the language of the policies to make sure that they're not misleading and that they're clear and that they're not being marketed in the wrong way. Is that one of your consumer protection functions?

Ms. BOWMAN. Absolutely. Every policy must be filed with us, and we review those. As a matter of fact, we have a rule and reg in Arkansas that those policies must be written at basically an eighth-grade reading level. It's called a Flesch Score—

Senator PRYOR. OK.

Ms. BOWMAN.—and that—that's a national—pretty much a national standard of how they must be written.

Senator PRYOR. All right, thank you.

Senator Lott?

**STATEMENT OF HON. TRENT LOTT,  
U.S. SENATOR FROM MISSISSIPPI**

Senator LOTT. Well, thank you, Mr. Chairman, for having this hearing. And I want to thank Senator Inouye, our full Committee Chairman, and Senator Stevens, for cooperating with our staffs and the Subcommittees to have hearings of this nature.

And I want to thank all the panel. You're all very interesting and very well qualified to help us in this area. But you did raise a number of questions that I'd like to pursue, so I ask my chairman and my colleague to bear with me, because this whole issue wells up so many questions and so many emotions in me that it's hard for

me to, you know, control all the concerns and the questions that I might have.

But let me just begin on the other—left side, or the right side from the audience, with Attorney General Hood from Mississippi. Thank you for being here. Thank you for your testimony. I thought you did a very good job. And thank you for the job you've done in the State. You took on the biggest boy in town, and I think you handled it very well.

I know it was a tough decision for you, because you had a lot of evidence of misconduct and fraud. But I think you chose a solution, rather than revenge, which was a very powerful force. And those of us that have suffered and bled together in Hurricane Katrina area, our whole state and our neighbors in Louisiana and Alabama and Texas, with Katrina and Rita.

I won't go into a long history, but this is particularly profound for me, because when I practiced law, I was with the firm that defended State Farm. And I've had my insurance—my entire life was State Farm insurance, although I'm pulling away from that as fast as I can now. And I lost my house. I didn't have a slab, because my house was actually about 8 or 9 feet up off the ground, and I just had dirt under the house. And when I got there, I didn't have a slab, I had nothing, just a plot of ground. And so, I have experienced all the difficulties that a lot of people have along the coast.

I also lost my car, a 2 year old, I believe it was, Escalade, General Motors product. I took it 12 blocks from the beach, parked on the north side of my office building, convinced it would be safe from wind and water. And when I got there, I opened the door, and water poured out. It had about 3 feet of water in it. It looked fantastic. Beautiful car. Only problem was, it wouldn't crank, and it was totaled. I wonder where it is today. And so, you know, I experienced that.

I was very interested, Commissioner—is that your title, Commissioner? Bowman—about how you require understandable language. Maybe I should move to Arkansas, because—

Ms. BOWMAN. We'd welcome you.

[Laughter.]

Senator LOTT. Well, going back to when I was trying to be a young lawyer, I always thought that the policy languages were a bunch of total gobbledygook. People don't have the foggiest, faintest idea of what they really have covered, or not covered. And we need to make sure that it is defined in plain English.

The reason why I know we need to do it is because the industry opposes that—you know, to have some area where it's highlighted what you have or what you don't have, in some understandable sense. If lawyers can't understand it, or if judges and lawyers will argue over it, what about the average man or woman working in the shipyard or in a poultry plant or in the Toyota plant in north Mississippi? So, we've got a lot of work to do here.

So, I've experienced it, and it's emotional with me, and I admit it. But, for the property and casualty industry—not just State Farm, but Allstate and Nationwide and all the others—to be denying claims when you—if you had a slab, it was concluded, "Oh, it was all water." Zero wind damage. Now, who believes that? Defies common sense. We were pounded for hours before the tidal surge

came in. And so, there clearly was wind damage. I was told, in my case, "Oh, no, no, you had no wind damage." And yet, we have all kinds of evidence to the contrary. After the fact, I actually found part of the siding of my house 35 feet up off the ground in a live oak tree. Still there. The water was not that high. It might have been 21 feet. No, wind put it up there. But I—so, I had no siding damage? The list goes on.

But what we want here—and at the same time claims were being denied and saying, "We're not going to provide insurance along the coast," and then eventually, "Oh, well, we're not going to cover, you know, homes statewide," the industry is recording historic profits, and CEO—State Farm CEO gave himself an 82 percent pay raise, or something of that nature. This is outrageous. And I have found them to be arrogant and meanspirited and convinced that they can whip Attorney General Hood and Congress and me and anybody else who gets in their way. Well, they may have a surprise coming. With the help of my colleagues, we're going to try to fix some of these problems.

And so, let me come to you, Attorney General Hood. Let me first introduce a document here. Maybe we should call this document D, because a couple have been—already been introduced. This is correspondence between engineers. It's identified—this came to my attention just yesterday—from [forensicanalyst.com](http://forensicanalyst.com). And they had been doing business with State Farm, but State Farm had stopped doing business with them. But the—these e-mails begin with, "Subject: We are back in business with State Farm for now." And then, this person says, "This is very good news, but I have serious concern about the ethics of this whole matter. I really question the ethics of someone who wants to fire us simply because our conclusions don't match his or hers. If State Farm is going to tell us what to put in our reports, then I think we have a situation similar to State Farm wanting my personal financial information. In my opinion, we need to find a more rational and ethical client to be dealing with."

Attorney General Hood, are you familiar with this document?

Mr. HOOD. Yes, sir, Senator Lott. We obtained this during our grand jury investigation. And I've heretofore been unable to comment about the document. However, yesterday, while I was on the plane up here, a lawyer found this in discovery, so it now is in the—it is in the civil realm. But this document, one sentence in here that I thought particularly disturbing for our Federal Government to be looking at was that the—they're talking about—in the second paragraph, about placing percentages of damage to property. Initially, State Farm requested that the engineers give them a percentage of damage, meaning wind versus water, whichever the percentage was. And then they came back and they wanted no percentages, because they said that they'd have to settle for that. And, two, what's more important for the Federal Government is that they were worried about having to prorate the Federal Government claims that they had already agreed and just allowed, without even investigation, the—us taxpayers to have to pay 100 percent on the Federal flood claims. So, I'm glad that this document came out, and this is what we were looking at in our criminal investigation.

Senator LOTT. Would you explain, as you understand it, exactly, now, who these e-mails are between? Who are these people?

Mr. HOOD. It's—Forensics is a North Carolina engineering firm that State Farm had engaged to handle some of their contract engineering examinations. Randy Down is the one sending the letter to Bob Kochan, who is the manager, or—and part owner, I think, of this *Forensics.com*.

What had happened was, State Farm was coercing them to change their engineering reports. And, in fact, they were going to—they did fire some of the people who wouldn't go along with them.

Senator LOTT. And you have a lot more evidence of this type in your files, I presume, some of which has not been made public, but—

Mr. HOOD. Yes, sir. I'm—I was unable to comment on them. And I thought it was unfair attacks for the industry to send a lobbyist up here—Racicot, I believe, was his name—to attack us on going after them down there. The last sentence down here in this particular e-mail, of the first aspect of it, it says, "It's obvious that State Farm would love to see every report come through as water damage so that they can make the minimum settlement. I now see why the Attorney General's Office is already involved down there." We had a case, but, had we indicted them, they would have left the State, shut down every claims office, and they would have left such a hole that the other companies could not have come in and filled it. So, we were left with a choice: indict them, they leave the State; or try to settle with 'em. And, as you spoke about, that's what we reached. And that's still going on. They haven't fully complied with the requirements that the Federal judge has placed on them to reach a final settlement. But these are the kind of documents that we've been—we've had to sit by and bite our lip and watch their comments of how innocent they are.

[The information referred to follows:]

From: "Randy Down"  
 To: "Bob Kochan"  
 cc: "Nellie Williams"  
 Sent: Tuesday, October 18, 2005 8:54 AM  
 Subject: Re: We are back in business with SF . . . for now!

Bob,

That's very good news. But I have a serious concern about the ethics of this whole matter.

Lecky (is this a man or a woman?) seems to be a very highly qualified adjuster to be making engineering conclusions that are more accurate than ours. I really question the ethics of someone who wants to fire us simply because our conclusions don't match hers (his?). If SF is going to tell us what we are to put in our reports then I think we have a situation similar to SF wanting my personal financial information. In my opinion we need to find a more rational and ethical client to be dealing with. Too many eggs in this basket to be risking it on SF. They had already contradicted themselves regarding the reports—with Mark (?) wanting percentages stated and his counterpart calling a few days later and telling us to resubmit two reports that had shown percentages and saying that SF absolutely does *not* want them shown because they would then have to settle for the portion that was reportedly caused by wind. I see now why other firms are bowing out.

Does this Lecky person understand that eye witness accounts are standardly included in a forensic report, when available? To ignore them would seem to be ignoring potential facts in the investigation that could hurt our credibility later.

Her concern about the emotional element in the engineer's decisions may have some validity (although I doubt It in Brian's case). But what about the obvious fact that SF would love to see every report come through as water damage so that they

can make the minimum settlement. I now see why the Attorney General's office is already involved down there. She needs to be careful about what she is doing and saying.

—Randy

—Original Message—

From: Bob Kochan

To: Randy Down; Nellie Williams

Sent: Monday, October 17, 2005 7:17 PM

Subject: We are back in business with SF . . . for now!

Good Morning gang!

Hope this finds you both well this AM. I managed to get us back on the roles with SF but we need to have a very frank conversation with the boys down south to be sure that we don't fall in the same trap.

Between us, the client feels that Brian relied solely on eye witness testimonies of others who were trapped in their attics and panic stricken at the time during the height of the storm. Very biased opinions of folks who may or may not have actually seen a significant portion of the storm's effect on the subject house. I have copied you both on an e-mail I sent to Brian last night in reply to his conversation with Lecky King about this matter.

We also will need to adjust Manny's report such that the conclusions are better supported. I happened to have been on that house site and was able to convince Ms. King based upon what I saw that the house roof first blew off weakening the walls and remaining structure then the tidal wave came through . . . now known to have been in the 35–38 foot high range . . . knocked down the rest of the structure and sent it floating away. Anyway she seemed to buy that but it is only because I explained to her where I saw sections of the roof and other debris. I also agreed with her in lot so ways. So we may need to redo the wording of that report.

Randy, as you were down and out this afternoon, I had to make a few decisions without consulting you . . . sorry but time was of the essence in this matter and timing did prove to be critical . . . I have committed to SF that we will send a new Structural PE to the site of Brian's investigation tomorrow and have him perform a separate and unbiased investigation of the loss. If we come up with the same determination, we will only bill for one report, the final one. If we come up with a different conclusion, we will absorb the total cost of both reports . . . But Nellie I will need for you to distribute the expenses over the other reports so we don't completely loose out OK?

Anyway I am calling for a conference call at 9:30 our time with everyone to go over this matter in detail and make sure we are all playing under the same guidelines.

Lastly, I will mention to you that Lecky told me that she is experiencing this same concern with the other engineering companies who are using engineers who happen to live in the area. In her words . . . They are all too emotionally involved and are all working very hard to find justifications to call it wind damage when the facts only show water induced damage. I don't know if that is the problem in our team's case but we must be careful that these reports have technically defensible conclusions when submitted.

I will call in as the leader and will await each of your contacts at 9:30 Tuesday AM.

Bye for now,

BOB

Senator LOTT. Yes. Well, of course, what we're looking for here are potential solutions—please, Mr. Chairman, bear with me, if you would—in how we deal with this in the future.

Now, one of the things that—it seems to me—and I should say this, not you—that the industry used flood insurance to make it appear that they were actually providing insurance to the customers. And so, if you had flood insurance, you paid flood insurance, maximum of \$250,000 per house, \$100,000 for content—then the companies, quite often, the same companies—in my case, State Farm—became the agent to get the money for flood insurance. They deliv-

ered the check and, in effect, said, "OK, congratulations, you got \$350,000, total."

One of the things coming out of the hurricane that is obvious to me is, we do need this flood insurance reform. We need to increase the level of coverage, and we need to increase what people pay. It's obviously not actuarially sound. Congress had to come in and bail out the program twice in significant amounts of money. And I just—I'm very suspicious that the industry uses this as a cover to make it look like they're really doing something. And, oh, by the way, they get a fee, of course, for handling this money—this claim, which is then given to their—the person that they insure, and then they deny it.

The other thing is, I do really think we need to take a serious look at the current exemption from the—from antitrust laws. The McCarran-Ferguson—it was done in 1940 under very questionable conditions and process at that time. Now, they will—they are using—the big boys are using the little guys to come up here and say, "Oh, my goodness, if you do that, we'll be put out of business, because we've got domestic companies in Mississippi and, I'm sure, in Arkansas and other States, and they use this rate-gathering process to determine what rates they're going to set." I'm interested in a solution here. And if there are some problems, I'd like to find a way of safe harbor, maybe, for the smaller companies or just a \$2 billion exemption, but find a solution. But what they don't say is—they complain about it, "Oh, well, we need this rate-setting capability." The truth of the matter is, the big companies really don't. And what—but they don't mention that it does allow collusion. And there's another area where I am very concerned that collusion is, in effect, allowed under this exemption. Do you have an impression of that, Attorney General Hood?

Mr. HOOD. Yes, sir. I don't recall any specific—our investigation was not geared toward—

Senator LOTT. Yes.

Mr. HOOD.—those aspects. That's something the Federal Government definitely needs to look into. And ours was strictly geared on the insurance fraud statute. It applies to insurance companies in Mississippi, and it applies to claimants. And our investigation was strictly looking at their claims practices. But I can tell you that, with the power that the industry has, as a whole, they can dictate to a State. New Jersey—I think they pulled out of the state of New Jersey.

Senator LOTT. Well, they pulled out of part of Alabama, and Alabama's Attorney General I don't think was going after them. And the Senators weren't raising as much Cain as I was, and didn't have the lawsuits pending as much. But yet—and they said, "But we're not going to cover that part down there in south Alabama." What was their problem?

Mr. HOOD. They're cherry-picking what areas they want to cover and they're dumping the rest off on the taxpayers through the State-funded Wind Pools. And, you know, I proposed, in response to their announcement that they were going to pull out, that if they're going to be licensed in Mississippi, that they ought to have—and they write all lines in other States, homeowners and so

forth—they ought to have to write it all over the State of Mississippi. That's what Florida did.

Senator LOTT. Yes.

Mr. HOOD. That was a proposal to try to respond. But perhaps that—that's maybe what the Federal Government should require and allow them to distribute the list—the risk nationwide.

Senator LOTT. Yes. Thank you very much, again, Attorney General Hood.

Ms. Bowman, I was interested in a couple of things you said. One, that rates don't—or, rates are not supposed to be affected in other States. As a matter of fact, my colleague Senator Larry Craig, from Idaho, who—I think his residence in the Washington area was on a boat. And he noted that his rates went up. And it had a tag line, in effect, saying, because of something to do with Katrina—Katrina was in his rate increase—his boat insurance was going to go up in Virginia. Now, how could that be?

Ms. BOWMAN. Well, it shouldn't. Now, you can get into reinsurance, and when you are talking about reinsurance, it could have an effect overall, because the insurance companies do reinsure, and the reinsurance companies are looking at an overall effect. It should be minimal because of how the risk is spread so thinly. It should be very small when you're talking about the risk that's spread. But, from State to State to a policyholder just at the company level, it should not. But I'm very surprised to hear that it would say "because of Katrina" that—

Senator LOTT. I was, too. And, apparently, so was he.

Ms. BOWMAN. Yes.

Senator LOTT. Because I suspect they use it as cover to jack up rates all over the country. And, at the same time, they were denying these claims and were refusing to insure, they're also asking the State insurance commissioner in our State, and probably other States, for 200, 400 percent increases.

Ms. BOWMAN. I would think that the insurance commissioner for that State would be interested in looking at that policy.

Senator LOTT. On your plain English, you—do you feel like, in your State, you know, plain understandable language is required? And do you get it?

Ms. BOWMAN. It's required. Do we get it? I think we get what is required. We get, in Arkansas, about 40,000 phone calls a year to our consumer services division. And a lot of those phone calls have to do with explaining what those terms mean and what those policies mean. I agree with you that saying that it's an eighth-grade reading level and understanding level may not be exactly what it is—

Senator LOTT. Right.

Ms. BOWMAN.—because I even have a hard time, sometimes, understanding—I mean, I'm supposed to be in the business, right?

Senator LOTT. Right.

Ms. BOWMAN. I agree that it is difficult to—

Senator LOTT. Right.

Ms. BOWMAN.—to understand.

Senator LOTT. Well, thank you for your efforts.

Mr. Hunter, it's good to see you again.

Mr. HUNTER. How are you?

Senator LOTT. I take it you would be, as you indicated, for some reform, if not repeal, of the antitrust exemption.

Mr. HUNTER. Yes.

Senator LOTT. I think you would probably be supportive of flood insurance reform in a variety of ways.

Mr. HUNTER. Including, I think, the Flood Insurance Program should prohibit its write-your-own companies, that they pay a very healthy fee to, by the way—

Senator LOTT. Right. Right.

Mr. HUNTER.—from allowing anti-concurrent causation-type clauses in their policies, which will—which has the tendency to dump risk onto the taxpayer that they don't deserve.

Senator LOTT. You think plain English makes sense?

Mr. HUNTER. Plain English makes sense, but the problem is, it's a complex legal document. I've talked to thousands and thousands of consumers. They understand every word, and they don't have a clue what's in there. They can read every word and understand it. It's in eighth-grade English, that's true. But—

Senator LOTT. The best lawyers—

Mr. HUNTER.—that doesn't mean anything—

Senator LOTT.—I know wrote those policies.

Mr. HUNTER.—because you have—the fact that you understand every word doesn't mean you understand a big, long, complex insurance policy, where clause 1—you have to look at clause 13, which refers you to clause 24. By the time they get three paragraphs in, they're lost, even though they understand the words.

Senator LOTT. It sounded like some of our government officials in the Federal Government—

Mr. HUNTER. Yes, it's like the *Federal Register*.

Senator LOTT.—wrote those policies. It's very, very—

Mr. HUNTER. When I was a government official, I used to write stuff that I understood, and, by the time the lawyers got it ready for the *Federal Register*, I had no idea what it said.

Senator LOTT. Yes. All right.

[Laughter.]

Senator LOTT. But, of course, I'm very anxious, also, about this damage to, you know, the title washing bill. And I know you've been supportive of that, and you mentioned it—the bill, in particular. Geez, you know, that, to me, looks like a—just a classic case of fraud or—I mean, it—it's—to me, it's criminal that you would be foisting off on an—you know, an innocent consumer a vehicle that, you know, looks good, but that's been totaled somewhere down the line by—because of a wreck, a flood, hurricane, whatever.

Mr. HUNTER. Absolutely. There has to be clear disclosure for the consumers to understand what they're getting. I mean, we—you can't possibly tell—a normal consumer can't—whether a car has been in a flood or an accident—

Senator LOTT. Right. But here's my concern. I actually had this bill, a year or so ago, when we were trying to move it, and what happens is, you know, very interested and good people wanted to add to it. And, you know, consumer advocates wanted to make it more wonderful. In Congress, the more wonderful you make the bill, the heavier it gets, and the more likelihood it'll die. This is an issue that needs to be addressed. It needs to be done this year. We

have bipartisan, bicameral support. I've talked to subcommittee chairman Bobby Rush in the House, Cliff Stearns, down in Florida, as a cosponsor. We need to move this clean and quick. And so, I hope that you would help us, you know, achieve that. It's one of these things we can do, because everybody seems to acknowledge it needs to be done.

And I want to thank the automobile industry for getting on the point here. You could very easily, in effect, be a participant—your industry—in this fraud. But, no, you are—your people wind up getting burned, quite often, and you do want honesty. You want to comment on that, Mr. Regan?

Mr. REGAN. Yes, sir. And thank you, Senator Lott, for your efforts, not only in the context of this legislation, but for years you've been on the forefront of trying to address title fraud, trying to address it legislatively. And I think your efforts several years ago, frankly, have helped, to a certain degree, to draw attention to this issue and to get some of the States to act collectively and try to move to more standard State titling legislation. But we've come to the conclusion that we need to look at this from a technology perspective rather than from the—

Senator LOTT. Well, and these automobiles not only leave the Gulf Coast hurricane area and wind up—

Mr. REGAN. Yes.

Senator LOTT.—in north Mississippi, where Attorney General Hood's from, they wind up in North Carolina or Virginia.

Mr. REGAN. Right.

Senator LOTT. So they clearly are involved in interstate commerce.

Mr. REGAN. Right. For every one retail transaction—

Senator LOTT. Or in Arkansas. We—

Mr. REGAN. Right.

Senator LOTT. We'll get the attention of—

Mr. REGAN. Yes.

Senator LOTT.—the Chairman here.

[Laughter.]

Mr. REGAN. For every one retail transaction, there typically are two wholesale transactions associated with that.

Senator LOTT. Yes.

Mr. REGAN. And we have industrywide support. We have the auctions that support this. The auction industry's two broad components—one, the salvage auction that disposes of vehicles that have been totally—that have been totaled; and the other auction—the other segment of the auction industry really facilitates the flow of vehicles that are basically ready for resale by retailers, and it facilitates the flow of those vehicles throughout the country. And if we could—if we could inject into the wholesale process this total-loss disclosure concept, it would enable the auctions to spot these vehicles, red-flag these VINs so that they—that basically you'd only have the curbstoners, who are the unlicensed, basically illegal, dealers of these vehicles out there. The curbstoners would be, kind of, the distributors of last resort here.

Senator LOTT. Right.

Mr. REGAN. And this legislation really is about attacking the fraudulent economic model of the curbstoners, as much as anything else.

Senator LOTT. Well, thank you all again for being here. You know what the greatest danger is? I've seen it happen many times over my 35 years in Congress. You have a disaster, you have an incident, and we're all fired up, and we're alarmed and determined to do something about it, and then time goes by, and your attention is diverted, and your passions cool, and it becomes—you get the money, and you hightail it, and you don't have time to actually address the law. We have a problem in this country with future expected cataclysmic disasters, natural and manmade. We need to think about these things.

If we could just work in these four areas that have been addressed here today, we could make a huge difference. Help us keep the attention on this, and let's try to find a way to get these targeted pieces of legislation done to help people all over this country when they're faced with future situations like we had.

Mr. Chairman, I believe my 4 minutes expired——

[Laughter.]

Senator LOTT.—about 20 minutes ago.

[Laughter.]

Senator LOTT. But thank you very much for your lenience.

Senator PRYOR. Thank you.

Senator Klobuchar?

**STATEMENT OF HON. AMY KLOBUCHAR,  
U.S. SENATOR FROM MINNESOTA**

Senator KLOBUCHAR. That's an act to follow.

Thank you all for being here. And I thought I would tell Senator Lott that one of my first jobs when I was in college was, actually taking consumer statutes and writing them in plain language for the Attorney General's Office of Minnesota. And I did that as a lawyer; now, I can say that I understand this issue. And I also was thinking, as I listened to all of you and appreciated Senator Lott's devotion to this issue, that during the recess, I was up in Grand Forks, North Dakota, and East Grand Forks and saw the damage there. Of course, it had been many years ago, and to the point where the flooding was two stories high, I think, and there were markers of where this flooding was, and I saw the tremendous rebuilding that's gone on, and how things can work when it's done well.

And so, I also have been very concerned, just hearing about what went on in the southern part of the United States. I've heard some of the stories around Minnesota. It just seems to me that when people have these things happen, they should be able to get insurance, it shouldn't be so hard to get these claims paid, and that there must be a better way to do this.

I just have a few questions about whether you believe that more Federal regulation of the property and casualty insurance industry as a whole is necessary, and if you'd like to see more Federal/State cooperation, and what Congress could be doing to make this go more smoothly and be better for the citizens of this country.

So, Attorney General Hood?

Mr. HOOD. I would like to see both State and Federal regulation. I've always supported the State's authority under law to cover. But there are gaps now that need to be filled. Basically, all the Federal regulation that you have is a Federal criminal prosecution. For an industry this large that can intimidate a State, such as things that they've done in Mississippi, is—and then they have—they have a PR machine that's incredible. You know, they keep talking about they've paid all these claims, but maybe 1 percent—you know, how they come at their percentages? They come at their percentages because those people that they call it a flood claim, they don't count those claims. They play with the statistics and the percentages. So, a State can easily be intimidated, leaders in a State. They pulled out of our State, for example, and stopped writing new policies. So, there has got to be—what you're doing, by looking at this issue, has probably kept them from completely shutting down and pulling out of the State of Mississippi—State Farm, that is. Allstate, Nationwide, the other companies are watching what's going on, as well. So, I thank you for investigating this issue. But I really think that we need to look at some of the antitrust aspects and have full Federal and State regulation.

Senator KLOBUCHAR. Thank you.

Ms. BOWMAN. I think that consumer protections are best done closer to the consumer, and so I'm more of keeping regulation at the State level. I think there are some areas that probably the Federal Government—the Federal Government already is in the business of insurance regulation, and I think that there are some areas that are better for the Federal Government to be in, and that would be the TRIA area, if we see that has—that has worked well, and probably should continue there. I think that's been a great incentive for the private companies to continue to write for those kinds of coverages.

And I appreciate that Senator Lott wants to look at the antitrust provision of McCarran-Ferguson. Just because it's been that way for a long time doesn't mean we ought to keep it that way. But I appreciate the fact that he wants to look at it carefully before we change it, because I am concerned about the domestic companies in Arkansas, the small companies, and the data-sharing information for ratemaking. That is important.

But, again, in—especially in the small States, when we're looking at consumer protections—I mean, we know a lot of our consumers on a first name basis, and they know us on a first name basis. And, again, we get those 40,000 phone calls a year in Arkansas, and they can call us, they know where to find us, they can come to our office. And we understand what they're talking about when they call us and they need help, and we understand the dynamics, you know, in the small States especially, when they ask us the questions. And when there is a disaster, when the small town of Dumas, in Arkansas, is—half of it is blown away by a tornado, we can get there immediately and go help them find their insurance agent or their adjuster and help them within just a matter of hours. And I think that's very important.

One thing, too, that I think we might want to consider, that I wasn't asked or—and I'm—sometimes I stick my nose where I'm not supposed to, but I do that anyway—is when we're talking about

flood insurance, perhaps we should consider—and the anti-concurrent-cause clause—consider an all-perils policy. And—you know, look at the all-perils. Have a company cover all perils so that you don't have the problem with the anti-concurrent-cause clause issue, so that you don't have to determine who's going to cover, whether it was wind, water, you know, something like that. That might be something for them to look at. And I think that some of the companies have been approached about this issue, and that it is doable. And perhaps looking at the flood program in a—maybe a different way, maybe as more of a backstop or a reinsurance. I think there are some ideas out there to look at. So, I appreciate the fact that this Committee—and I told Senator Pryor this yesterday—I appreciate the fact that this Committee is looking at insurance as it hasn't in the past several years. I think it's very timely, and I really do appreciate it. I think it's—I think it's very important.

But, again, your—I've gone beyond your question, but I'm a woman and I'm a lawyer, and so I do that all the time. But I do think—in answer to your question, I do think State regulation, as far as insurance is concerned, the more we can keep there, the better. But, again, there are some places where—that we need your help, and—at the Federal level.

Senator KLOBUCHAR. OK. Thank you very much. I have to get going, but I will maybe talk to the two of you about this in the future. So, thank you.

Thank you very much.

Senator PRYOR. Thank you, Senator Klobuchar. Thank you for coming today.

I have a few more questions for the panel. I'm not going to try to use my entire 4 minutes like Senator Lott did.

[Laughter.]

Senator PRYOR. But I may be close to that.

Let me ask, if I can, Mr. Regan, about S. 545.

Mr. REGAN. Yes.

Senator PRYOR. When I was the Attorney General in my State, we had some hurricanes. I don't remember if they were in Florida or exactly where. And, sure enough, we saw some—a lot of salvage vehicles come in our State, and all kinds of problems. And, one of the things we learned very quickly is, our salvage title law at the State level needed some cleaning up. But the problem is, we could clean ours up, but they could still come from other States, like Senator Lott talked about a minute ago. So you think that S. 545 will fix that problem nationally?

Mr. REGAN. I think that the approach of Senator Lott's bill, which is to push total-loss information into the public domain faster than that information trickles through the DMV process and the titling process, will help significantly. This is really the last set of data that are collected in fairly discrete places that—you know, basically, the computer databases of the insurance companies. If we can push that data out, at the same time continue to push the State DMV data out, then I think the combination of those two sets of data will be very powerful. It—you know, to say that it will fix the problem is a big task, because this is a very—as you well know, this is a very, very complex set—complex issue with a lot of complex players and a lot of different stakeholders. But the last—really

the last big unknown out there, I think—or we think, as an association—is the total-loss data. If we can get that into the public domain, that will be a very powerful tool, very powerful information set.

Senator PRYOR. Some in the insurance industry—not all, but some—have been reluctant to have a VIN-based disclosure. Do you know why they're reluctant?

Mr. REGAN. I think, as I've—we've said in our written and in the oral testimony, they basically have a self-economic interest. Even if they comply fully with State titling laws, not every vehicle that is declared a total loss necessarily gets a salvage title. So, if you're still complying with State law in pushing that vehicle through the State titling system, it may not require a salvage title, and the cleaner the title, the higher the purchase price at salvage auction. Whereas, if Senator Lott's bill were to become law, that vehicle would be red-flagged—you know, that VIN would be red-flagged, basically, as soon as the total-loss settlement occurs. Then you get less at salvage auction. You know, that's—if you look at it in that small box, then it's—the insurance company may take a hit. But we think that the public interest demands that you look at it, at the big box; the big box being, you know, what happens to that vehicle after it gets sold at salvage auction? And questions that we raised in my oral testimony, you know, how is that vehicle reinsured? Why is it not in the economic interest of all the insurance companies to know that a total loss has been declared so that, you know, they're not in the business of shifting that, you know, one bad apple, you know, from one company to the other?

Senator PRYOR. Let me ask this, too. Why shouldn't the law require that, at the point of sale, there be a notice or a sticker or something on a sheet of paper posted in the window so that there is a notice to the consumer about the status of that vehicle and whether it has ever been salvaged?

Mr. REGAN. In—

Senator PRYOR. Why shouldn't we do that?

Mr. REGAN. In 1988, that very question was addressed at great length in the context of the Federal Trade Commission putting the Car Buyer's Guide rule into place. And ultimately, the point-of-sale notice requirement, whether it's condition of use, whether it's notice about a specific defect in the vehicle, that approach was rejected, in the context of that very extensive rulemaking; and, instead, the FTC chose to use a different approach, which is—the Car Buyer's Guide says, "Here's what your warranty is. If you have a warranty, here it is," whether it's, "You know, if you don't have a warranty, it's as-is. If you do have a warranty, it's either limited or there's the manufacturer's warranty." Or, if there's an extended service contract, there's a box to check on that. And also, that Buyer's Guide encourages the individual to get the vehicle inspected. You know, the bottom line, there is no substitute to buying a vehicle from somebody you know and trust or, if you're not in that position, there's no substitute to having the vehicle inspected. And so, it is—you know, the—while I appreciate your concerns there, in essence, the Federal Trade Commission has kind of addressed that, and has chosen—in the 1990s, they reexamined the rule, and they agreed to stick with the same choice.

Senator PRYOR. OK.

Let me ask Mr. Hunter, if I may, about a software issue, when it comes to claims adjusting and investigation. I'm aware of two types of software. One's called Colossus, one's called Claims Outcome Advisor. And there are probably others on the market; I'm not just picking on those two. But, as I understand it, some people that have looked at that software believe that when claims adjusters and companies are using that software, they will systematically underpay on claims. Is that your experience? Could you tell the Committee about that?

Mr. HUNTER. Yes, that's—there seems to be a—an ability—and I would encourage you to look at the book “From Good Hands to Boxing Gloves,” which explains how it was used in Allstate, and—the “boxing gloves” being if you don't accept their offer, which is a lowball, you go—you end up in court. And that was the recommendation of McKinsey, and that's where that quote came from, McKinsey's suggestion to Allstate of how to implement this. And that became the title of the book by a trial lawyer who brought a case and got these slides of McKinsey, who introduced Colossus. Colossus, COA, Claims IQ, were three systems that deal with—those are bodily injury claims. There are other systems that deal with property damage claims, like Xactimate and some others that are used, I'm sure, down in Mississippi, when the—after Hurricane Katrina. So, you have different types of systems, some of which at least have the appearance, according to lawsuits and this book, of ability for the management to dial in a savings that they want to achieve in the claims process for the following year. And that, obviously, is a extremely serious situation, and there doesn't seem to have been any market-conduct examinations that have caught it. There have been very few market-conduct examinations that have even touched on it by the States.

Senator PRYOR. Should that market conduct be evaluated at the State level or the Federal level?

Mr. HUNTER. State—well, I think it should be evaluated at the Federal level, because I think there are some serious questions about how come suddenly all the—you know, many insurance companies are using these systems. And some will say, “Well, it's because my competitors are suddenly able to come in with lower rates, because they're saving so much money on claims.” But, nonetheless, whatever it is, it's not fair to the people who are hurt.

Mr. HOOD. Senator Pryor, may I—

Senator PRYOR. Yes, sir.

Mr. HOOD.—speak out of turn about this issue of software? This is something that we've found in our investigation that's disturbing, that the softwares are programmed differently for the cost payments on the Federal flood program versus the insurance policies themselves. For example, in the programs it's set up to pay a dollar for sheetrock removal, where—for flood program—for us taxpayers to pay it—whereas, if the insurance company pays, you know, they only pay 60 cents. And I'm not sure if it's square footage or—I actually have that calculated. But I do know, for us taxpayers, it's a dollar to pay it, for the insurance companies, it's 60 cents.

Senator PRYOR. And you found out—you found that out through your investigation?

Mr. HOOD. Yes, sir. I think some of those documents are actually out in public domain, under—where some civil lawyers have discovered documents. It's—they're running about 9 months behind us, and I can try to lay hands on those public documents, where those—that has occurred, as well, and that's set up in their software system.\*

Mr. HUNTER. And it's not just claims. We have black boxes that are being used to price hurricane insurance that are—a lot of States have no clue what's going on inside those black boxes. And then there are black boxes being used by Fair Isaac and others to come up with credit scoring surcharges, which sometimes can be 100 percent if you happen to be poor. And things like that, that are beyond the regulatory reach of the States, because it used to be that every time a price was varied within a insurer's pricing system, it was through either a rating bureau or by the insurer, and was regulated. But it isn't true anymore. It's not regulated.

Senator PRYOR. Mr. Hunter, let me also ask—Ms. Bowman, a few moments ago, mentioned an all-perils policy. I'd like to get your thoughts on that.

Mr. HUNTER. I ran the National Flood Insurance Program. I actually would think a all-perils policy would be good. But I'm very concerned about giving the Federal Government more authority right now, given the Flood Insurance Program. The Flood Insurance Program promised the taxpayers—that we tried to administer when I was running the program—was that we did a—we—was to—in exchange for a program that gave subsidized rates to people, the future building would be done wisely, and that the—and the land use would be controlled in a way that—and new construction would be paid—would be charged full actuarial rates. We required that flood maps were updated every 3 years.

In Hancock County, Mississippi, recently, there were 76 new flood maps. On average, the old flood maps were 20 years old and were 10 feet too low. So, people were building what they thought were safe houses, and they were actually 10 feet below the level. People who thought they were outside the floodplain were actually in the floodplain, because the floodplain was much bigger, because the water is much—was much higher.

If the Flood Insurance Program cannot be administered soundly, why would you expand it to anything new—wind or anything like that? If a—if the program is encouraging unwise construction through—and charging inadequate rates; therefore, the—if I build 10 feet below the flood level, I should pay a very high actuarial rate, according to the program—but if a—if the program thinks I'm actually at the 100 percent level, when I'm not, it's not going to charge me much of a rate at all.

So, you have all these problems in the current Federal program. I would be first in line for a—an all-perils policy involving the Federal Government if we had a way to fix the flood program and show how the program—

Senator LOTT. Would you allow me to jump in?

\*[The information referred to is retained in the Committee files.]

Senator PRYOR. Sure.

Senator LOTT. Maybe we could do this—

Senator PRYOR. Sure, go ahead.

Senator LOTT.—together.

My colleague from Mississippi, Congressman Taylor has an all-perils bill that he's introduced in the House. I've been taking a look at it. A couple of my concerns are that—you know, how would that work? And even though I might not sound like it, I still want to leave as many things as I can in the private sector. I don't want us to become the insurance company for all disasters in America. I'd like the private sector to do that.

The other thing, though, is—I'm concerned that—for instance, I saw one proposal that was written up in, I think, *The New York Times*, that—where some of the big companies have proposed, "Well, yes, we ought to have that. And, by the way, we ought to say that any disaster that's over \$6 billion, the Government would pick up the rest." Well, geez, nice, thank you very much. In other words, "If there's any kind of a problem, we're going to kick it off to you guys."

And—for instance, I've always—I have supported, since 9/11, the terrorism insurance. And then, when it came up for renewal in 2005, there was resistance from the Office of Management and Budget to extending it. But I was convinced that we still needed it. But, this time, I'm not going to support the extension, because what has happened is, the private sector hasn't stepped in to provide the coverage, because the Government is doing it.

So, and the—

Mr. HUNTER. I total agree—

Senator LOTT.—Government's not doing it very well. And, by the way, you know, we've got to have terrorism insurance for, you know, buildings in Rankin County, Mississippi. I don't think that terrorists are going to hit Rankin County.

Mr. HUNTER. Yes.

Senator LOTT. So, I don't—just—those are a couple of key questions that I've got to get—you know, settled in my mind. How do you respond to it?

Mr. HUNTER. Yes. Well, I—well, first of all, as you know, I have historically opposed the extension of the terrorism program, too, because I don't think it's necessary, and I think the industry can handle it, except for nuclear/biological/chemical. I don't—I do think they need help in that area. But—and I'm—I have historically opposed expanding the catastrophe coverage nationally, too; in part, because of the serious, awful problems in the flood program. If the Federal Government is going to mess up one program, I don't think we should give them another one to mess up. I think it should be done as some kind of reinsurance, where the flood part would be reinsured, but that it would be done under a—under some kind of formula where the industry had a piece of the action, some skin in the game—a lot of skin in the game on everything, except maybe some of the flood and some of the terror—the very high, mega-catastrophes. But I don't—I don't even want to go that far yet, because I'm afraid that the Federal Government, as—FEMA has run this program has made it a mess. And I am—therefore, I'm reluctant to have—to endorse any kind of even multiperil policy. But it

could be designed in a way that would maximize private-sector involvement, and work, but it has to work with real active involvement and oversight by the Federal Government.

Senator PRYOR. Ms. Bowman, did you want to add something?

Ms. BOWMAN. I did. Can you tell I'm on the edge of my seat?

I was not at all advocating that the Federal Government take over the all-perils policy at all. I think the private sector—the private market would do that. The companies would do that. I agree, the Federal Government should not expand in that area. And then the flood program would become the reinsurance, possibly, for the all-perils, in some fashion. And, of course, that would take a lot more study. Again, the devil's in the details, always. But certainly, as I mentioned, and maybe wasn't clear on, the companies—I believe that some representatives from the National Association of Insurance Commissioners has talked to some higher-ups, whoever they may be, from some of the bigger companies who say, “Yes, we think that is a possibility of our writing the all-perils policies for—including flood, and to take care of this anti-concurrent-cause clause.”

Senator PRYOR. Attorney General Hood, let me follow up on that, on the anti-concurrent causation. What is the status of that right now in Mississippi? How does that stand in your State right now?

Mr. HOOD. A Federal District Court judge made that finding, and it's now—and the industry has it on appeal to the Fifth Circuit, as to whether or not it—that clause is valid. He did it on an ambiguity—

Senator PRYOR. OK.

Mr. HOOD.—issue.

Senator PRYOR. So, in other words, a Federal judge looked at it, saying, “Ambiguous. It's going to be construed against the writer of the policy, the drafter of the contract,” and so, right now is it for all insurance companies or just the one company?

Mr. HOOD. The court is applying that same rule of law in dealing with all the companies on the anti-concurrent cause provision.

Senator PRYOR. OK. So, as it currently stands in Mississippi, it's on appeal. But the insurance companies lost that argument at the trial-court level. But on a national level, these anti-concurrent causation clauses are in insurance policies all over the country. Is that right? Is that fair to say?

Mr. HOOD. Yes, sir, that's what I understand, that most every State has that. And that's been their argument, that the insurance commissioners approved it. But that's not—the—a State court has the right to decide—and a Federal court, based upon State law—what is a—an ambiguous provision, or whatever. And it's our position that that's a violation of our consumer protection statutes, because it's a bait-and-switch. Anti-concurrent cause clause, as this Federal judge described it in his opinion, is that if wind weakens your house, blows the roof off, as we found in some reports, and then you get an inch of water in your property and it further weakens the structure, and then it blows it away, they don't owe you a dime. Nothing. And here's—let me just tell you, at—this is good example. My roof in—up in Jackson; I'm about 160 miles inland—on the house I have blew off. They—State Farm, my insurance, they paid for my roof, no problem. But take Senator Lott's house,

down there. If it blew it off in—at my house, 180 miles inland with 100-knot winds, think what it did to his house down there. They zeroed him out. They say, “We don’t owe you a dime, because it’s the anti-concurrent cause provision.” Now, that’s just ludicrous. And that’s what they’re actually—I didn’t believe that they would do it. I didn’t believe they would use that. But in their own court filings—we’ve got documents where they—they’re arguing all this in court, and they’re taking it up on appeal. They’re actually doing it. Some of the smaller companies go, “Wait a minute, y’all are abusing this. You know, you’re going to get us all beat, and they’re going to strike this clause nationally.” And that’s probably—hopefully what will be the outcome of all this, the way they’ve strong-armed people—and other companies, too. Allstate, some of the others, have been using it, as well—abusing it.

Mr. HUNTER. The fact that it’s in every State is proof of the weakness of the oversight. This is—if ever there was an—a dishonest, intellectually ambiguous at least—intellectually ambiguous, if not-in-the-words ambiguous—it’s at least—no one could imagine that, “My roof blows off and then an inch of water 3 hours later, I get nothing.” You just couldn’t possibly believe it, “No, my company wouldn’t do that.” People come to an insurance company with trust. And these guys were—that is such a despicable clause. The fact that every State has approved it is just—it’s a—an embarrassment for State regulation.

Senator PRYOR. Attorney General Hood, let me ask you, on the salvage title issue with automobiles, have you had a salvage title problem in your State that is related to Rita and Katrina? And a second question is, is the State able to know—where the vehicles that have been totaled as part of the hurricane, and have been supposedly salvaged out as part of the hurricane—do they know where those vehicles have ended up?

Mr. HOOD. No. We—you know, as—you just have to deal with what staff we have in our consumer protection.

Senator PRYOR. Sure.

Mr. HOOD. We were dealing with price gouging and all those things. We did investigate some of the motor vehicles. We rattled the chain really hard, threatened a lot of the wholesalers, basically, if they didn’t disclose, if they had any idea—so, we just tried to beat it down with just practical applications. But Arkansas, they bring titles over to Mississippi and wash them—

Senator PRYOR. Yes.

Mr. HOOD.—because ours is so lax. And, you know, there was a lot of chop-shops in the hills of northeast Mississippi, and there was a lot of problems with that. This is a law enforcement issue that they’re raising on this bill. You remember, it started probably during your tenure as AG. State Farm actually came forward. Now, I don’t know what caused them to. But us AGs settled with State Farm—

Senator PRYOR. Yes.

Mr. HOOD.—where they had—they had—they’d have a title, they’d buy it in, and it would be in the name of the person who wrecked the car. Then they would take it to a auction. It would sell, and State Farm’s name was never in the title, so you never knew that it was actually a totaled vehicle. We worked—

Senator PRYOR. They'd wash it. They'd wash the title.

Mr. HOOD. Yes. We worked with them, and they sent people back to Mississippi and every State in the Union, and us AGs worked with them. They paid for this, to go track those vehicles down and pay those people the difference between a wrecked car and a—and I bragged on them in that. In fresh releases—I like working with the industries when they do the right thing. And it is a problem, and, I think, nationally, if we had a standard titling system, where that title is stamped “totaled vehicle” or something, it would really help the consumers.

Senator PRYOR. Yes. I think that's right, too.

One last question for you, Attorney General Hood. We've talked a little bit about how some of these insurance companies deliberately, systematically try to underpay claims, and there are some incentives built in with their adjusters, et cetera, to try to meet goals and underpay claims. Is it your experience, after Katrina, that that is still going on in your State?

Mr. HOOD. It is. In their software—there again, it's required for—if you have three—like carpenter, plumber, and—three people, contractors you have to hire, then you're entitled to a—an overhead and profit. And you're—because you're acting as a general contractor. You're spending your time off of work, and things like that, to organize these efforts. We're going to have to go back now and look at all of these claims for the failure to pay overhead and profit, because they'll delete—they will shut that provision off in their software, and they will refuse to pay that to homeowners who have no clue that they're entitled to additional money. The homeowners would think, “I'm not entitled to any additional money for that.” But you are. I mean, you're entitled to be able to hire a general contractor and give them that money. And so, we—I feel comfortable, based upon the activity I've seen down there, the way they've handled these claims, we're going to probably have to go back and re-evaluate all of these claims with all these companies. And that's a systematic problem that has been found nationwide. There's been several class-actions nationally in other States, where they've had to go back and pay a lot of these damages. So, that's a—that's the next battle that I've got on the front, and I'd—I'm hoping we can get this settlement behind us on this one, and then move on and make sure that they're paying that under the settlement that we have on the table.

Senator PRYOR. OK.

Senator Lott?

Senator LOTT. Mr. Hunter, and maybe Commissioner Bowman would like to get in on this, too, why is it so difficult to determine what rates will be in the insurance industry? I mean, you have to set rates or prices in all kinds of industry, but we have this special carve-out for the insurance industry. And I—I don't understand why that's so complicated or difficult, even for a little domestic company, you know, to decide what rates they're going to charge.

Mr. HUNTER. Well, it is an actuarial calculation, and it does require historic data. And the—but the argument that they're not—that if you repeal the antitrust exemption, that a small company could not have access to data is wrong. It's just wrong. If you go back to the testimony—Representative Jack Brooks had hearings

on the—in the House Judiciary Committee—lengthy hearings, and I think you’ve read, maybe, the—some of the report, because that’s where all this oddity of how it—how the bill passed, the McCarran Act, with people being assured that it was only a 2-year moratorium and all that, and it turned out to be a permanent moratorium, with a little word-changing in conference. And the—but if you look at the testimony of the hearings, they had these—many experts at—in antitrust law testify, and they said—every one of them, regardless of their point of view about whether to—the bill should be—whether you should repeal it or not—every one of the experts said that the collection and dissemination of historic data—purely historic data—would pass muster, because it would be a pro-competitive act. So, small companies would still have the data they need. And the—and there’s no doubt about it, if you review that—and I think you see the same kind of things from the Antitrust Commission and others—that that would happen. If—the question—where the insurance industry currently is doing things that would be illegal if you—is when they actually project the—those historic data into the future and estimate, “Well, what’s it going to cost next year? What do you think is—loss is going to be next year? How much is inflation going to be?” All—but these are things of competition, how much is inflation going to be and questions like that. I mean, if—why don’t you allow builders to have a—their own building antitrust exemption? Because they—it would be nice for them to be able to know what the—to all agree together on what the bricks and labor are going to cost next year, and just add their own profit. But that’s what they have today. The insurance ratings organizations, the cartel-type organizations, not only collect the historic data, they project it, they manipulate it, they decide how to tweak it, how to—what law changes mean, and things like that. They do all these things that competitors should do by looking at the market. And small companies would be protected, in terms of getting their historic data. They would just have to make their own adjustments to the data. And there are plenty of actuaries available, and others, to do that. There are consumer actuaries and other kinds of actuaries, public actuaries. There are more public actuaries than there are actuaries working in the—like, ten times more consulting actuaries than there are actuaries working in rating organizations.

Senator LOTT. What about it, Commissioner Bowman? Do you have any comments on that?

Ms. BOWMAN. Well, there are several things that go into rate-making. One is loss costs, and there are other expenses and things like that. And when you’re looking at experience, for instance, you need to look at the population. For instance, for the smaller companies, there—you need to look at credible data. And when you have the smaller companies, their population is going to be smaller. For instance, for nursing home liability, you may only have a population of five nurses. And so, their loss experience is not going to be very credible. As opposed to if you were able to pool that data and you’re looking at the loss experience from thousands of nurses, what has happened in the past, so that you can predict the future.

Senator LOTT. Thank you.

Mr. Hunter, do mutual companies pay a less corporate effective tax rate than stock companies?

Mr. HUNTER. I think so, but I'm not really an expert at it. I—

Senator LOTT. Well, who—

Mr. HUNTER.—think that you'd better ask somebody else.

Senator LOTT.—who is? I can't seem to find out anybody who can help me—

Mr. HUNTER. I believe they get a—I believe they get a tax break, but I—but I'm not absolutely sure how it works.

Senator LOTT. OK. I'll find somebody else to answer that.

Let me just conclude my participation—thank you, Senator Pryor, for having the hearing and for allowing me to have a little extra time—I do think we need to look at some law changes in some of these areas that we've mentioned. But, also, I always am an incurable optimist at—I believe there's a way to get a—you know, a result of all of all this. What I'm looking for here is for the insurance industry to pay—go back, to pay the claims that have been filed, the lawsuits, settle those, pay the claims, review the claims—and I'm talking about all the companies, particularly the big three. What we want is the people to get fair treatment. That's all we're really looking for. But that also has to include providing insurance statewide, including the last foot before you jump into the Gulf of Mexico, at an affordable rate and a reasonable rate. That's one of the problems that bothers me. While they're not settling, and jacking rates, and not paying people, they're making—they're having these historic, outrageous profits on the backs of the people that need coverage.

So, what a—you know, if we can find a way to do those three things, I think, you know, the companies will be better off, and I know the people will be better off.

Thank you all for your time.

Senator PRYOR. Thank you.

Senator Nelson, thank you for joining us today. I know you've been in a very similar hearing in the Banking Committee.

**OPENING STATEMENT OF HON. BILL NELSON,  
U.S. SENATOR FROM FLORIDA**

Senator NELSON. Thank you, Mr. Chairman. We're trying to move a bill that Senator Lott is cosponsoring in trying to address this overall question of affordability and availability of insurance, which is a critical question in the State of Mississippi. It's a critical question in Florida. And in trying to address that, to bring consensus in an industry that has no consensus, as to what should be the Federal role; where, indeed, there's just outright warfare between insurance companies and reinsurance companies, and the reinsurance companies don't want the competition of State catastrophe funds. The bill also addresses whether or not there should be a regional catastrophe fund as a backup before you ever get to the question of should there, or should there not be, a Federal catastrophe fund, and all of these things.

But you're, Mr. Chairman, focusing more on the oversight of this insurance industry. And I take it that, as I've been testifying in the Banking Committee, you've been going into things like the anti-trust exemption and so forth.

Let me just mention, from my own experience, that one of the problems is, we have a revolving door in the regulation of insurance. An insurance commissioner in most of the States is appointed, not elected, as they are in Mississippi and as they used to be in Florida until I left, and then the insurance industry had its way and got the insurance commissioner appointed; and, by the way, in Florida, not even appointed by one person, like the Governor, so you can have accountability; he is appointed by the Governor and the entire cabinet. And albeit the insurance commissioner is doing an excellent job, and he's a professional, and he worked for me when I was the elected insurance commissioner; nevertheless, what happens in most of the States is a revolving door. I want you to hear this, Senator Lott. The person who is appointed insurance commissioner comes out of the insurance industry and he or she is there, on the average, less than a year. And guess what happens in the revolving door? Goes right back into the insurance industry. Now, that's one of the things that could help tighten up the regulation of insurance.

The NAIC is an excellent organization. And they, by the way, have endorsed our bill to try to build this emergency consensus commission on the insurance catastrophe. Hopefully, they're going to weigh in on this, because when the big ones hit, Katrina and Rita, they were Category 3's. And a Category 3 did to your coast, Senator Lott, exactly what you would expect a Category 3 to do. But what everybody didn't expect was, on the back side of the hurricane, in the winds from north to south, all of the additional water caused the drainage canals to drain into the main canals, the canals filled up, the pressure built and breached the canals in two places, and the rest of the bowl of New Orleans filled up, with all the attendant economic and personal loss that occurred.

So, I know you've got one of the best right there because I used to get him to help me. And yet, we've got a problem. And we've got to address this problem. And I don't know how to address it, other than trying to do it the way we were confronted in the mid-1990s in Florida, with a paralyzed marketplace, and that is to reach out and build consensus. The argument that I made today in the Banking Committee—look at the experience of Katrina. It's well over \$200 billion of economic loss, and guess who has paid most of that? Uncle Sam. Well over \$100 billion that Uncle Sam is shouldering. And, as a result, at the end of the day, in these major kind of natural catastrophes, the Federal Government's going to pick up the tab. So, why don't we have a rational system in which to pick up the tab, and where risk ought to be allocated, and how you best mitigate that risk? And that means a lot of things, not just, you know, catastrophe funds; that means building codes being enforced and new building materials and new building structures and better weather forecasting.

By the way, we've got a satellite under the jurisdiction of this Committee that has gone on the blink—no, it hasn't gone on the blink—it's a 5-year designed life. We're at the end of the fifth year. If that satellite goes caput on us—it has improved our accuracy on the prediction of the path of a hurricane by 15 percent—if it goes out, we are—and we don't have a replacement. And, of course, that, in this Subcommittee that I chair, is one of the alarm bells that

NOAA or NASA or somebody needs an additional \$400 million. We put that satellite up within 12 months, from start to finish. We could do that on this particular satellite. That's just another part of this very complicated problem.

I didn't ask a question. I just pontificated.

[Laughter.]

Senator PRYOR. Do you want to ask a question?

Senator NELSON. Well, I would hate to go by the opportunity of hearing all of these eminent witnesses without saying something, but what do you think about what I said, Mr. Hunter?

Mr. HUNTER. You know I always agree with everything you say, Senator.

[Laughter.]

Mr. HUNTER. You weren't here when I said that my daughter, who lives in Hollywood, just got her premiums charge of a little over \$5,000, and can't afford it, and wants to know if she can still stay in Florida.

Senator NELSON. It has gotten so bad. People cannot afford to stay in their homes because of the double whammy of property taxes and insurance premiums. And that's the subject upon which we just testified to the Banking Committee, with Governor Crist.

Mr. HUNTER. Well I think what Florida did was—in the special session, was very thoughtful and wise, to disintermediate some of the reinsurance. Because I was asked, then, to come down and do some of the calculations for the State, and we found that the reinsurers were charging up to ten times their own actuarial rate calculation in the layers we were looking at. And so, as a result, they were—and they admitted, when we talked to them privately, that they were greedy.

Senator PRYOR. Any other questions?

Senator NELSON. Well, I would just add this. Part of the way that we worked our way out of the problem back in the early 1990s, after the monster hurricane, Hurricane Andrew, people could not get insurance from the private marketplace. All right? The entire economy of a state such as Florida was operating on the availability of homeowners insurance because if you don't have homeowners insurance, you can't build homes, and you can't sell homes, and you can't make loans on homes. Now, I have just mentioned three major industries that are the engines of a state's economy: construction, real estate, and banking. The way that we had to address it, since the private marketplace did not respond—because the insurance companies wanted to pull out, and they were; we had 11 insurance companies go bust after Hurricane Andrew. We had insurance companies fleeing the state of Florida. And those who stayed, like Allstate, canceled 50,000 policies. By the way, they're doing that in droves right now as a result of the 2005 hurricanes.

So, where was the only place that people could get homeowners insurance so that the State did not economically grind to a halt? It was a quasi-government insurance company. Then, it was called the JUA, the Joint Underwriting Association. Today it's morphed into a bigger creature called Citizens Insurance Company.

Interestingly, what the legislature of Florida has just done is, the previous law said that you could only get insurance from that crea-

ture as a last resort, if it wasn't in the private marketplace, and the rates in that creature—then the JUA, now Citizens—had to be higher than the normal marketplace, because it was last resort. Problem was, last resort was the only place that people could get insurance. So, today the legislature in Florida has made that quasi-government insurance company a competitor of the private marketplace, much to the chagrin of the insurance companies. They don't want the competition. But you can't have it both ways. You can't say, "You're going to have the free reign of the market competition, and then you did not, Mr. Insurance Company, offer the free marketplace insurance policies so that people could buy them."

So, now we're suddenly seeing, just as a result of that one thing—the Governor just testified this morning that he's seeing rates come down as a result of that.

Would you comment on that, Mr. Hunter?

Mr. HUNTER. Yes, I—I think that the expansion of Citizens into full homeowners policy and the competitive approach is wise. If you look at several States that have done competitive State funds for worker's comp, they've worked quite well, and have stabilized some tough markets.

What bothered me more than anything—and I even mentioned this earlier, before you came—is, when I was commissioner in Texas, and before that, when I was working with Florida, when the Academic Task Force was working on the post-Andrew stuff—is that the industry—basically, we said we need three things, we need models for rates, because we would—and we agreed with them—and they—and—but it meant doubling, tripling, quadrupling the rates—they said we needed a Citizens or someplace to dump our high risks, and we need to cut our coverages with deductibles and other things. And if we do that, and we understand it's going to be painful, in the future you're going to have stability. That was what they told me in Texas. And I believe that's what they told people in Florida, too.

But now we don't have that stability. And that, to me, is—especially at times of incredibly high profits, for them to be acting so precipitously people—to drop people, to jack up prices, double, triple, just—and walk away—I find that just very hard to take, given the promises that were made a decade ago.

Senator NELSON. There's a phrase, Mr. Chairman, in insurance that is typically applicable to health insurance. And the phrase is "cherry-picking." And what it means is that an insurance company is going to cherry-pick, like picking cherries, the risks that it wants to insure. Well, guess what those risks are? Those risks, in health, are the less risky person, the healthier person, the younger person. They don't want to insure the old and infirm because that's where they're going to have to pay out. So, too, in the property and casualty market. What you're seeing is, they want to shed this risk because they feel like it's too much of a risk. They want to make money on less risk because they have more certainty of making money.

Now, that's the way, if you're running a business, you'd certainly like to have it. But what are they in the business of? They're in the business of insuring risk with a commodity that is, now, not a luxury, it's a necessity because you can't own a home unless you

have insurance, unless you don't have a mortgage. You can't drive a car unless you have insurance because it's State law. And you sure better have some health insurance. And if you don't, we see the consequence of that with 44 million people who are uninsured, of which all of the rest of us pay, because they do get healthcare.

I think we've got to rethink this whole issue. Now, I don't know that I'm where Senator Lott is with regard to the antitrust exemption. I just simply haven't immersed myself into that enough. But I know that we're at a time in which the Federal Government, if it is going to pay the tab of a major catastrophe, at the end of the day, we have to have a more rational system. And the private marketplace, that normally would work, will not work when the risk is so high that no one company can withstand the risk. And that's what we are presented with regarding these potential natural catastrophes. And it doesn't have to just be a hurricane; it can be an earthquake in San Francisco, or an earthquake in Memphis; it can be a tsunami, of which we have seen the effects over in Asia; it could be any number of things. And we've got to get our mind above this and ahead of the power curve.

Thank you, Mr. Chairman.

Senator PRYOR. Thank you, Senator.

We're going to keep the record open for 2 weeks for Senator who want to submit questions in writing.

Also, I noticed Senator Lott offered some documents. We'll certainly make those part of the record.

And I want to, again, thank the witnesses for being here. I know you traveled distances to be here, and I appreciate you all being here. And we're going to continue to look at insurance issues over the course of this Congress, and I really appreciate you all getting us started on the right foot.

So, the hearing is adjourned. Thank you.

[Whereupon, at 11:15 a.m., the hearing was adjourned.]

## A P P E N D I X

### PREPARED STATEMENT OF MICHAEL R. CALVIN, INTERIM PRESIDENT AND CEO, AMERICAN ASSOCIATION OF MOTOR VEHICLE ADMINISTRATORS

Thank you for providing the American Association of Motor Vehicle Administrators (AAMVA) the opportunity to provide a written statement for the printed record to clarify some information about the National Motor Vehicle Title Information System (NMVTIS), state motor vehicle titling laws and Passenger Vehicle Loss Disclosure Act (S. 545).

AAMVA is a state-based, non-profit association representing motor vehicle agency administrators and senior law enforcement officials in the United States and Canada. Our members are the recognized experts who administer the laws governing motor vehicle operations, driver credentialing, and highway safety enforcement.

NMVTIS is a system that allows an electronic means to verify and exchange titling, brand, and theft data among motor vehicle administrators, law enforcement officials, prospective purchasers and insurance carriers. NMVTIS allows state titling agencies to verify the validity of ownership documents before they issue new titles. NMVTIS also checks to see if the vehicle is reported "stolen"—if so, the states don't issue the new titles. Brands are not lost when the vehicle travels from state to state, because NMVTIS keeps a history of all brands ever applied by any state to the vehicle.

NMVTIS, once fully implemented nationwide, will allow access to a variety of vehicle-related information for consumers, dealers, lenders, insurance companies, law enforcement officials and state motor vehicle administrators. AAMVA and its membership have continuously demonstrated its ongoing belief in NMVTIS by investing more than \$25 million of AAMVA money for development, deployment, marketing and maintenance of the system. This investment by AAMVA far exceeds the investment made to date by the Federal Government in this federally mandated system.

Through AAMVA's continued efforts to implement the system, data on approximately 55 percent of all registered vehicles in the United States is available through NMVTIS (See Appendix A). Many of the states have seen tangible benefits from using NMVTIS (Appendix B). For example, in March 2005, the state of Florida cracked a car theft ring responsible for cloning more than 250 cars worth \$8 million and it was able to identify cloned vehicles prior to issuing new titles as a result of working with other participating states of Arizona and Virginia. As another example, the state of New Hampshire has benefited from the recapturing of brands lost by other non-participating states—1,760 in 1 month, which helps to eliminate washed titles. As you can see from these examples, AAMVA has been successful in our effort to complete the implementation of NMVTIS. What Congress must remember is that the implementation of NMVTIS is still the responsibility of the Federal Government. AAMVA, as the operator of NMVTIS on behalf of the Department of Justice, has developed and is operating the system that has been fully implemented in several states. Additionally, a number of other states are currently in development, and several other states, while not fully on-line with NMVTIS, are providing data to the system.

A nationwide role out of NMVTIS has been severely hampered by a lack of Federal funding for this Federal mandate. Additionally, the continuing failure of the Department of Justice to complete its rulemaking responsibilities regarding the reporting of total loss information from insurance companies, as well as information from junk and salvage operators, has also contributed significantly to the delay in fully implementing the system. Federally authorized reviews of the system, as well as the events of September 11, 2001, have also contributed to implementation delays. If Congress would provide the necessary funding, and prompt the Department of Justice to complete its rulemaking responsibilities, it would be more compelling for the remaining states to become on-line participants in NMVTIS.

AAMVA believes the long-term NMVTIS financial model initially envisioned by the association, when fully implemented, will be self-sustaining. The AAMVA Board of Directors developed and approved a financial strategy that would ensure the eco-

nomic viability of the system. This plan is based on an annual fee structure for participating states that will, when all states are fully implemented, provide the funding necessary for the operation and maintenance of NMVTIS. This funding plan does not, at this point, include any potential revenue that could be generated by providing information to private sector users, but those potential future revenues could be used to lessen the financial impact on the states.

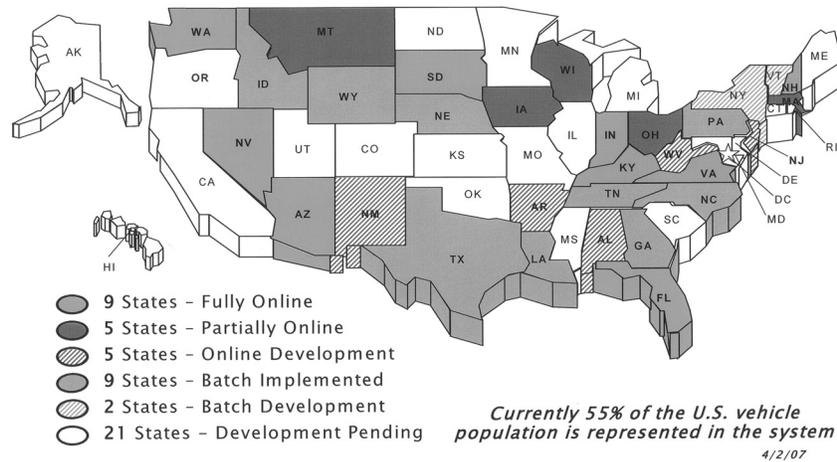
AAMVA continues to strongly believe that the Federal Government should fund NMVTIS until it has been implemented nationwide (See Appendix C). As a result of the support from members on this Committee and other Members of the Congress, both the House and Senate included a soft earmark in the FY 07 Commerce, Justice, and Science Appropriations bill, however the year-long CR eliminated all projects.

Thank you for the opportunity to comment on the current and future status of NMVTIS. AAMVA continues to believe that, when fully funded and implemented nationwide, NMVTIS can meet all of the original intentions of the Anti-Car Theft Act of 1992, including public access to pertinent vehicle information prior to their purchase of a vehicle. If S. 545 moves forward from the Committee, AAMVA request that language be added requiring (a) that the total loss information be supplied to NMVTIS and (b) the Departments of Justice and Transportation work together in order to adopt the same terminology in order to prevent confusion.

We appreciate support from members of the Committee in trying to get Federal funds in the FY 07 CJS bill and we would appreciate if the Committee can help get the Department of Justice to complete their required rulemaking, and look forward to working with all interested parties to ensure the successful nationwide implementation of NVMTIS.

APPENDIX A

NMVTIS Participation



APPENDIX B

PARTICIPATING STATES REAP TANGIBLE BENEFITS FROM NATIONAL MOTOR VEHICLE TITLE INFORMATION SYSTEM (NMVTIS)!

**Arizona**

- Has detected 15,864 possible stolen vehicles.
- Identified cloned vehicles prior to issuing new titles as result of working with other participating states of FL and VA.
- Identified duplicate titles initiated by a crime ring using Canadian documents.
- Has realized a closer and more efficient working relationship with law enforcement.

- Has experienced a reduction in customer wait time and the ability to identify problems upfront due to online, accurate data.

#### **Florida**

- In March 2005, FL cracked a car theft ring responsible for cloning more than 250 cars worth \$8 million.
- Identified cloned vehicles prior to issuing new titles as a result of working with other participating states of AZ and VA.

#### **Indiana**

- BMV Title Supervisor, who has oversight of NMVTIS, declared “*NMVTIS is the best tool ever used!*”
- Stated that NMVTIS identifies brands *daily* that were missed by non-participating states (*i.e.*, titlewashing).
- Has experienced a great reduction in lawsuits by consumers who were given clear titles with missing brands (*e.g.*, salvage, rebuilt).
- Has realized a closer and more efficient working relationship with law enforcement.

#### **Iowa**

- Since August 16, 2004, IA Motor Vehicle Enforcement has investigated 161 reported stolen vehicles—resulted in seizure of stolen vehicles and apprehension of suspects.
- Has carried forward brands that would have otherwise remained “washed” from the titles.

#### **New Hampshire**

- Identified cloned vehicles prior to issuance of a new title which eliminated additional clones.
- Saves time and money by no longer requiring clerk to manually update state record with returned title information—NMVTIS does is instantly!
- Benefit from capability to track which vehicles are moving to be registered in another state.
- Have detected possible stolen vehicles—46 theft notices received in 1 month.
- Has benefited from the recapturing of brands lost by other non-participating states—1,760 in 1 month—eliminates washed titles.
- NH’s MV Supervisor, who has oversight of NMVTIS, stated the amount of funds spent to implement NMVTIS “*represents a small fee considering the savings on . . . insurance fraud, cloning vehicles, stolen vehicles, odometer fraud, preventing washed brands for consumer protection—all thanks to NMVTIS!*”

#### **Ohio**

- Has experienced “exceptional cooperation” with OH Law Enforcement, consumers, licensed OH dealers and motor vehicle insurance carriers.
- Since August 2004, has detected 3,817 possible stolen vehicles through NMVTIS.
- Since August 2004, has carried forward 22,458 vehicle brands through NMVTIS.

#### **South Dakota**

- Has captured brands lost by other non-participating states.
- Saves time and money by no longer requiring clerk to manually update state record with returned title information—NMVTIS does is instantly!

#### **Virginia**

- Has seen a 17.47 percent decrease in motor vehicle thefts since 1992.
- Averages 8,640 hits on stolen vehicles per year.
- Has captured brands lost by other non-participating states.
- Discovered “cloned” vehicles prior to issuing new titles as result of working with AZ and FL.

## APPENDIX C

## NMVTIS TIMELINE AND FEDERAL FUNDING PROVIDED

- 1992
- Anti-Car Theft Act passed; DOT has oversight of NMVTIS
- 1993
- 1994
- 1995
- 1996
- Initial funding from DOT—\$890,000
  - Pilot states are identified
  - Anti-Car Theft Improvements Act is passed, moving NMVTIS from DOT to DOJ
- 1997
- Initial DOJ funding—\$1 million
  - Additional pilot states are identified
- 1998
- DOJ funding—\$2.8 million
- 1999
- Pilot completed
  - GAO recommends DOJ perform a life-cycle cost benefit analysis
  - DOJ funding frozen (combined w/2000 appropriation)—\$3.05 million (had been \$3.15 million; \$100,000 deducted for GAO cost benefit analysis)
- 2000
- System in production
  - GAO still conducting cost benefit analysis
  - DOJ funding frozen (combined w/1999 appropriation)—\$3.05 million (had been \$3.15 million; \$100,000 deducted for GAO cost benefit analysis)
  - June—GAO publishes its cost benefit analysis report: the system is found to have the potential to save consumers from \$4 billion to \$11.3 billion annually
  - DOJ releases FY99/00 funding—\$6.1 million
  - 9/11 occurs and the emphasis moves from vehicle to drivers/identification issues
  - No funding received for 2 years
- 2002
- No Federal funding provided
- 2003
- DOJ funding—\$3 million
- 2004
- DOJ funding—\$494,700
- 2005
- No Federal funding provided
- 2006
- IJIS releases a report for DOJ reevaluating NMVTIS and concludes that “NMVTIS program provides an invaluable benefit to state DMVs and the public community as whole”
- 2007
- The U.S. House and Senate included NMVTIS in both the FY 07 CJS spending bills but Congress did not enact individual appropriations bills.

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PREPARED STATEMENT OF THE NATIONAL ASSOCIATION OF REALTORS

**Introduction**

The National Association of REALTORS® (NAR) appreciates the opportunity to present its views on property and casualty insurance to the Committee on Com-

merce, Science and Transportation. We thank Chairman Inouye and Ranking Member Stevens for holding this hearing to investigate this issue of concern to homeowners and commercial property owners in the Gulf Coast and other regions of the country.

The National Association of REALTORS® is America's largest trade association, representing more than 1.3 million members involved in all aspects of the residential and commercial real estate business. Ensuring the availability and affordability of property and casualty insurance, therefore, is a top priority for members of NAR.

The storms that hit the Gulf Coast region in 2004 and 2005 have had a significant impact on the availability and affordability of property casualty insurance for homeowners and commercial property owners in the region. These effects have been felt up the Atlantic seaboard as far north as New England. Even states that have not suffered catastrophic losses in decades are feeling the effects of insurance companies not renewing policies and refusing to write new policies, especially in coastal areas. In addition, the costs associated with the Federal recovery efforts from these storms are being borne by taxpayers across the country.

It is for these reasons that NAR strongly encourages the members of this committee and Congress to develop a comprehensive policy that will protect property owners, address insurance availability and affordability, acknowledge the importance and limitations of markets, and recognize the respective responsibilities of property owners and all levels of government.

#### **Overview**

The catastrophic events of 2004 and 2005 have shown the need for a comprehensive, forward-looking natural disaster policy. Such a policy would recognize that property owners, private insurance markets, and all levels of government must work together in order to successfully address the problems (*e.g.*, lack of available and affordable property insurance) currently plaguing disaster-prone areas.

The availability and affordability of property insurance is, at its core, a consumer issue. The importance of available and affordable insurance to homeowners, commercial property owners and those who would like to own their own home or place of business cannot be overstated. Unfortunately, it is also something that consumers nationwide—even those who are not in what have traditionally been considered “disaster-prone” areas—now know all too well.

The National Association of REALTORS® believes that any real solution to the insurance problems now facing this country must go beyond a discussion of natural disaster insurance and include a comprehensive natural disaster policy that addresses, but is not limited to, insurance availability and affordability. A comprehensive natural disaster policy also should take into account the responsibilities of multiple actors including property owners, insurance companies and each of the different levels of government in preparing and paying for future catastrophic events. Consequently, although this hearing is titled “Oversight of the Property and Casualty Insurance Industry,” our statement offers suggestions for what REALTORS® believe should be included in a comprehensive approach to addressing future catastrophic natural disasters.

#### **Residential and Commercial Properties at Risk**

A strong real estate market is the linchpin of a healthy economy, generating jobs, wages, tax revenues and a demand for goods and services. In order to maintain a strong economy, the vitality of residential and commercial real estate must be safeguarded.

Today, insurance availability and affordability concerns are not limited to the Gulf Coast region. We have heard from REALTORS® in numerous states, including New York, New Jersey, South Carolina and North Carolina, expressing concerns about the availability and affordability of property insurance. Their insurance concerns extend beyond homeowners' insurance and include multifamily rental housing and commercial property casualty insurance.

Insurance is a key component to financing the purchase of real estate. Without property casualty insurance, lenders will not lend; without insurance, borrowers are typically in default of their mortgage terms. The limited availability and high cost of insurance, therefore, not only threatens the ability of current property owners to hold onto their properties, but also to slow the rate of housing and commercial investment in these communities. Either of these threats could, in turn, further delay the rebuilding of communities on our storm-ravaged coasts.

The inability to obtain affordable insurance is a serious threat to the residential real estate market, impacting not only single family detached homes, but condominiums, co-operatives and rental units as well. New home purchases, resale transactions and housing affordability are affected in the following ways:

- *Homeowners' insurance is a necessary component in securing a mortgage and buying and selling a home.* If a potential homebuyer is unable to obtain or afford the required insurance, the sale will not be completed. As a result, potential homebuyers are excluded from the market.
- *The cost of owning a home is directly tied to insurance costs.* Homeowners are required by their mortgage lenders to maintain homeowners insurance, regardless of its cost. If the homeowner is unable to afford the cost of that insurance, the mortgage is in default and the lender may foreclose. If disaster insurance coverage is required, potential buyers may choose not to purchase a home because the insurance they need is too expensive. If disaster coverage is optional but expensive, owners may choose to go unprotected.
- *Insurance costs impact rent levels.* Insurance costs incurred by multi-family property owners are ultimately passed on to tenants through higher rents. This impacts housing affordability, particularly for low-income renters.

Many of NAR's commercial members in the Gulf Coast and coastal regions have also reported problems with commercial insurance availability and affordability. Members have experienced large increases in premiums—in some cases more than four-fold with concurrent increases in deductibles and decreases in coverage—and in some cases, a complete lack of availability. These changes put the property owner at greater financial risk to recover from losses, while also affecting property values since dramatic insurance increases often cannot be passed on to tenants. For example, in the multifamily housing sector, the ability to pass on increased insurance costs in the form of higher rent is often limited by market conditions, rent stabilization laws and strict limits imposed on federally subsidized landlords. The commercial property owner faces similar problems because leases may cover more than 1 year and may include limitations on the amount of expenses that may be passed on to the tenant. Thus, when insurance costs rise from \$0.10 to \$0.50 cents per square foot, the landlord must absorb most of the increased costs.

Often it is the smaller property owner that suffers the greatest. Small owners cannot offset the increases in insurance costs for one property with lower insurance costs in other parts of the country; nor are they able to negotiate a lower multiple property rate. In commercial real estate, there is a point at which insurance becomes unaffordable—when insurance expenses are so high that the property no longer generates sufficient income to cover expenses. This problem forces many owners to sell their property.

#### **Catastrophic Natural Disasters are a National Issue**

The catastrophic events of 2004 and 2005 should serve as a wake up call that highlights not only the importance of having insurance, but also that individual property owners, insurance companies, all levels of government, and taxpayers have a role in preparing for and recovering from future catastrophic events. The ongoing recovery from these storms shows that all taxpayers in the country have a stake in a Federal natural disaster policy because their tax dollars are funding recovery efforts.

As a result of the 2004 and 2005 hurricanes, attention has focused on Florida and the Gulf Coast states, but other areas of the country are also susceptible to large-scale natural disasters. Damage caused by any of the following events could be as great as, if not greater than, that caused by Hurricane Katrina: a repeat of the 1906 San Francisco earthquake, another 1938 "Long Island Express" hurricane, or a significant seismic event along the New Madrid fault, which extends from northeast Arkansas, through southeast Missouri, western Tennessee, western Kentucky to southern Illinois. While it is true that not all areas of the country are susceptible to the large-scale disaster scenarios above, the effects of these disasters certainly would be felt by all taxpayers.

#### **Elements of a Comprehensive Natural Disaster Policy**

The National Association of REALTORS® encourages Congress to develop a comprehensive natural disaster policy that encourages personal responsibility, promotes mitigation measures, ensures insurance availability, and strengthens critical infrastructure (e.g., levees, dams, bridges, etc.). NAR supports the creation of a Federal natural disaster policy that will promote available and affordable homeowners' insurance in disaster-prone areas.

NAR supports the creation of a Federal policy to address catastrophic natural disasters that:

1. Protects property owners by ensuring that transparent and comprehensive insurance coverage is available and affordable, with premiums being reflective of the risk involved;

2. Acknowledges the importance of personal responsibility of those living in high-risk areas to undertake mitigation measures, including the purchase of adequate insurance;
3. Provides property owners adequate incentives to undertake mitigation measures where and when appropriate;
4. Acknowledges the importance of building codes and smart land use decisions while also emphasizing that proper enforcement of both is best left in the hands of state and local governments;
5. Recognizes the role of States as the appropriate regulators of property insurance markets while identifying the proper role of Federal Government intervention in cases of mega-catastrophes; and
6. Reinforces the proper role of all levels of government for investing in and maintaining critical infrastructure including levees, dams, and bridges.

NAR believes that now is the time for Congress to address a comprehensive natural disaster policy that includes natural disaster insurance. The lack of a national natural disaster policy has had a measurable direct impact on the availability and affordability of property casualty insurance in many parts of the country. The inability to obtain affordable homeowners' insurance is a serious threat to the residential real estate market—and thus, our economy.

Homeowners and commercial property owners need insurance to protect themselves, their families and their property in case of catastrophe. However, if insurance is not available or affordable, many make the unfortunate, but understandable, decision to purchase only the minimal amount or type of insurance required. This is precisely the decision many Californians have made—buying the required property casualty coverage but foregoing earthquake insurance due to its high cost. The problem with this rational economic decision is that if “the big one” hits, and people are not insured for that type of catastrophe, then the American Taxpayer, that is to say everyone in the country, will pay. NAR believes that people who bear risk should pay a fair share—by obtaining and maintaining adequate insurance coverage.

Property owners should have confidence that their homes and businesses will survive future catastrophic events. Appropriate mitigation measures can help to create that confidence. Federal and state governments can provide incentives (*e.g.*, tax credits, insurance rate reductions) to property owners to undertake appropriate mitigation measures for their homes and businesses. Research conducted by the Multihazard Mitigation Council of the National Institute of Building Sciences found that a dollar spent on mitigation saves society an average of four dollars.<sup>1</sup>

States are the appropriate regulators of property insurance markets, but there is a proper role for the Federal Government in addressing mega-catastrophes. Some disasters are just too large or unpredictable for the private market to deal effectively with the resulting damage. At some level, there may be an appropriate role for the Federal Government to intervene in insurance markets to prevent market disruption and insolvencies among insurance companies. The level of intervention, however, must be set at a level that will not interfere with normal market forces. The difficulty lies in determining the level at which such intervention would be appropriate.

Finally, an essential part of a comprehensive natural disaster policy is the recognition of the basic responsibility of government at all levels to build and maintain infrastructure. Hurricane Katrina was not the largest hurricane to ever hit the Gulf Coast, but the failure of the levees protecting New Orleans contributed significantly to the loss of life and property from that storm. *USA Today* reported on January 29, 2007, “The Army Corps of Engineers has identified 146 levees nationwide [including three in Hawaii, two in Alaska, and 13 in Arkansas] that it says pose an unacceptable risk of failing in a major flood.”<sup>2</sup> According to the article, the City of Hartford, Connecticut last year spent \$5 million to repair levees to protect thousands of properties worth approximately \$2 billion—properties that otherwise would have been required to purchase flood insurance.<sup>3</sup> The cost of maintaining levees can prove very costly, but is a relative bargain when compared to the potential loss of life and property as shown by the failure of the levees in New Orleans. Moving for-

<sup>1</sup> Multihazard Mitigation Council, “Natural Hazard Mitigation Saves: An Independent Study to Assess the Future Savings from Mitigation Activities, Volume 1—Findings, Conclusions and Recommendations,” National Institute of Building Sciences, Washington, D.C. (2005), p. 5.

<sup>2</sup> Peter Eisler, “146 U.S. Levees May Fail in Flood,” *USA Today*, January 29, 2007. [http://www.usatoday.com/news/nation/2007-01-28-levees\\_x.htm?POE=NEWISVA](http://www.usatoday.com/news/nation/2007-01-28-levees_x.htm?POE=NEWISVA).

<sup>3</sup> *Ibid.*

ward, NAR believes that all levels of government must do a better job of shouldering their respective responsibilities.

To summarize, NAR believes that it is in the best interests of all Americans to have a comprehensive Federal natural disaster policy that includes aggressive mitigation and appropriate assumption of risk so that affordable insurance for homeowners and commercial properties is available. Having a comprehensive natural disaster policy is essential in the coming years. There is no guarantee that 2007 or any future years will be as benign for natural catastrophes as 2006. The question is not whether there will be another Katrina-like event in size and scope of destruction, but when. As we have learned, it is far less costly to prepare ahead of time than to fund recovery efforts.

#### **Proposed Legislative Approaches**

Congress has, with varying levels of success, debated and voted on natural disaster legislation since the 1990s. The National Association of REALTORS® encourages a healthy and vigorous debate during the 110th Congress that leads to sound and productive legislation. NAR supports the efforts of Members of Congress, especially Senators Bill Nelson (D-FL) and Mel Martinez (R-FL), who have introduced and co-sponsored seven bills to address this critical issue.

Legislation introduced in the Senate during the 110th Congress takes different approaches to addressing the natural disaster insurance issue including: allowing insurance companies to accumulate tax-deferred catastrophic reserves (S. 926), allowing homeowners to create catastrophic savings accounts similar to health savings accounts (S. 927), offering mitigation tax credits (S. 930), streamlining regulations for “surplus lines” of insurance (S. 929), creating a Federal fund to sell reinsurance to states with catastrophe funds (S. 928), funding hurricane research (S. 931), and creating a bipartisan commission to study various insurance-related ideas and report back to Congress (S. 292).

Mitigation has been proven to save money in the long-run. Ensuring that infrastructure is sound, as shown by the comparison of Hartford and New Orleans above, can also be life-saving. NAR believes that all reasonable proposals should be considered as part of a comprehensive solution to address future catastrophic events. The ultimate result of any legislation should be to ensure that property casualty insurance is available and affordable to homeowners and commercial property owners.

As a first step toward creating a comprehensive natural disaster policy, NAR strongly encourages the Senate to enact legislation to reform the National Flood Insurance Program in order to ensure its long-term viability.

#### **Conclusion**

Thank you again for offering the opportunity to present to the Committee the views of the National Association of REALTORS® on the need for a comprehensive natural disaster policy. NAR encourages Congress to develop a comprehensive approach to natural disaster preparedness that encourages personal responsibility, promotes mitigation measures, ensures insurance availability, and strengthens critical infrastructure (*e.g.*, levees, dams, bridges, etc.).

Passage of an appropriate comprehensive national disaster policy is a top legislative priority for REALTORS® nationwide. We stand ready to work with the members of the Committee on Commerce, Science, and Transportation and others in Congress to develop a responsible natural disaster policy that addresses the needs of consumers, the economy and the Nation.

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#### RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. MARIA CANTWELL TO JULIE BENAFIELD BOWMAN

*Question 1.* It appears in the wake of large past catastrophes such as Hurricanes Katrina and Rita, insurance companies are choosing to reduce significantly their risk exposure by increasing deductibles, non-renewing policies, and not writing new policies. You mentioned in your testimony that, due to the New Madrid fault, parts of Arkansas are at risk for earthquakes. As you know, Washington State is also at risk for earthquakes. Even so, it has been reported that nearly eight out of ten Washington homeowners are not covered by earthquake insurance. First, a homeowner must qualify for earthquake coverage. Next, there is usually a high deductible and—given the value of the average home today—the homeowner faces paying out tens of thousands of dollars before coverage would kick in. Finally, the premium frequently proves to be too expensive given the perceived risk and perceived risk mitigation. Based on your experience in Arkansas and as a member of NAIC, do you believe that there are functioning State markets for earthquake insurance?

Answer. The availability and affordability of earthquake insurance nationwide is limited by the willingness of insurance companies to cover it, and for those that are, by the willingness of consumers to pay for it. This is true even for state-run entities like the California Earthquake Authority, where the take-up rate is around 14 percent largely because the coverage is expensive and comes with limitations. Insurers perceive the potential severity of a massive earthquake to be in the hundreds of billions of dollars; an amount that could threaten the solvency of the entire industry. In areas of known seismic risk, where the insurance is clearly most needed, there is little market to speak of. In areas where there is relatively low earthquake risk, coverage is readily available at modest prices.

*Question 2.* Should residential earthquake insurance be included in a standard homeowner's policy for areas where there is a significant risk of earthquakes?

Answer. Currently, earthquakes largely are an uninsured peril, particularly in areas where the threat is greatest, due to the cost and availability of covering it. Mandatory inclusion of earthquake coverage would address the uninsured aspect, but not the affordability aspect. Offering earthquake coverage as an optional coverage also does not address affordability. Hurricane Katrina has shown us the two prongs of the problem: the lack of comprehensive coverage, and the high cost of providing this coverage. We can't solve one without addressing the other. An all-perils insurance policy that closes gaps in coverage and gets more people insured is good public policy, and we support that concept, but Federal Government involvement, or spreading the risk through capital markets may be necessary to spread the risk over time and help make such coverage affordable.

*Question 3.* Should the structure of the home and the contents of the home have separate deductibles? What are the implications for separate deductibles rather than a single deductible when filing a claim?

Answer. Generally there is not a separate deductible for the dwelling and the contents. If a greater amount of risk is retained by the homeowner, prices will be lower to reflect the lower loss costs passed to the insurer. Thus, having two deductibles instead of one would result in the homeowner retaining a greater portion of the risk. While this would result in lower prices, it might add confusion to an already complicated product.

*Question 4.* An earthquake endorsement in a standard homeowner's policy generally excludes damages or losses from floods and tidal waves—even when caused or compounded by an earthquake. However, loss caused by landslide, settlement, mudflow and the rising, sinking and contracting of earth may be covered if the damage resulted from an earthquake. I can see the parallels between Attorney General Hood's testimony regarding anti-concurrent causation clauses with respect to Katrina and the earthquake insurance policies offered in my State. Has NAIC taken a position on insurers use of anti-concurrent causation clauses in their policies?

Answer. The anti-concurrent cause language in a standard property insurance policy is a direct result of the bifurcated insurance system we have, and was developed by the insurance industry to protect insurance companies from having to pay for losses which are excluded from coverage and for which they did not collect a premium. Some have suggested that, following Hurricane Katrina, this provision allowed companies to avoid paying their obligations of coverage when flood damage was present. This is *not* the intent of that language, and the vast majority of companies do not distort the provision to shirk their obligations. Despite this, there have been serious allegations that some companies or adjusters have wrongly denied claims while misconstruing this provision, and they are now being forced to defend that contention to their insurance department or in the courts. The fact that insurers feel compelled to structure their policies to create legal barriers to segregate various perils (with the cost to defend these legal barriers often factored into rates), and those barriers add confusion and uncertainty for policyholders who are now challenging those barriers in courts, speaks to the need for an all-perils insurance policy. An all-perils policy would effectively eliminate the need for the anti-concurrent language along with any possible distortion or manipulation of its intent.

*Question 5.* What if any role should the Federal Government play when it comes to earthquake insurance?

Answer. If earthquake insurance is combined under an all-perils policy, the cost for those in seismically active areas could make the coverage unaffordable. All-perils insurance solves the public policy problem of personal responsibility where those at risk are purchasing the right insurance, but does not address the other problem of affordability. The Federal Government should work with the states to develop mechanisms to address the affordability issue. Again, delivering comprehensive coverage will eliminate gaps in coverage and confusion, and then the states and the Federal Government can focus on making that coverage affordable.

*Question 6.* I take it from your testimony that you believe repealing the anti-trust exemption under McCarran-Ferguson Act could harm the property and casualty insurance market, particularly for smaller companies, by threatening or eliminating the use of well established market mechanisms. What are these key specific market mechanisms?

Answer. The existing market mechanisms that could be threatened or eliminated if Federal antitrust law were applied to their operation include:

- policy form standardization;
- joint underwriting and residual market underwriting (*i.e.*, high-risk pools);
- sharing loss cost data;
- statistical activities conducted by rating and advisory organization; and
- operation of state insolvency funds.

Each of these practices benefits consumers and helps foster a competitive market for insurance. It is the smaller and medium sized insurers that would be particularly harmed if these practices were narrowed or eliminated by operation of the Federal antitrust laws. Economists have long argued that an efficient and effective market for insurance depends upon the sharing of information. Smaller insurers with less claims experience, less sophisticated databases, and fewer resources benefit from access to collective data about the marketplace. Limiting the availability of this critical factual information will set up barriers to smaller insurers entering into and effectively competing in the market. Standardized insurance forms and definitions of risk also enhance competition by easing comparison shopping for consumers and allowing for improved data sharing pools for calculating loss costs. Joint underwriting provides a method for insurers to share risk that no insurer would assume alone such as high-value or high-risk properties. A lead insurer in cooperation with other insurers spread the risk by each insuring a portion. The limited Federal antitrust exemption guards these collaborative efforts from charges of anticompetitive behavior. Repealing the limited antitrust exemption would squeeze those collaborations and limit the insurance options available to owners of high-value or high-risk properties. It would likely chill the ability of any single insurer to write a policy that assumes total risk and to secure reinsurance as a backstop at a reasonable rate. Finally, rating and advisory organizations collect and disseminate statistical information, compile aggregated loss cost data helpful in trending analyses, and provide other services that allow small and medium-sized insurers to compete, thereby improving pricing and choices for consumers. Without rating organizations, small and medium sized insurers would be harmed by the lack of available loss cost information necessary for complete knowledge about the risks they seek to insure.

*Question 7.* As you know S. 618, the Insurance Industry Competition Act of 2007 amends the McCarran-Ferguson Act to make the Federal Trade Commission Act applicable to the business of insurance to the extent that these businesses are not regulated by state law. What is the danger of having the FTC provide a floor for consumer protection with respect to property and casualty insurers for States?

Answer. State insurance regulators have as their primary mission the protection of consumers. Every state has antitrust and unfair competition laws, unfair trade practices laws, and laws and regulations specifically directed at insurance sales and claim practices. State regulators and attorneys general play complementary and supportive roles in monitoring and investigating insurers, agents, and brokers to prevent and punish activities prohibited by those state laws. These activities involve constantly reacting to changing market conditions and practices that are often state-specific. It also involves taking an active role and making adjustments to methods and policies that anticipate new challenges that threaten consumers and market stability. Every day conscientious, skilled, experienced regulators monitor and investigate business activities related to the two major obligations insurers owe to consumers—issuing sound policies and paying claims on time. Current Federal expertise and capacity necessary to evaluate insurer conduct and practices is limited, at best, because of the long and successful history of state regulation. It would take time for Federal officials to become sufficiently expert in the business of insurance to effectively establish consumer protections and there is a risk that any Federal standards would conflict with or lower existing state protections. Market uncertainty concerning which enforcement regime is applicable will harm consumers and insurers.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. MARIA CANTWELL TO  
J. ROBERT HUNTER

*Question 1.* In 2002, Washington State enacted legislation restricting the use of credit scoring in insurance. Insurance companies can no longer use credit history to cancel or non-renew an individual's insurance policy. Insurance companies also can no longer deny coverage or determine premiums using the absence of credit history, the number of credit inquiries, collection accounts identified as medical bills, the initial purchase or finance of a vehicle or house that adds a new loan to the person's existing credit history, the total available line of credit, or use of a particular type of credit card, debit card, or charge card. Even with Washington State's strong laws, I continue to have concerns regarding the potential disparate impact the use of credit scores has on protected classes of consumers in my state, and more broadly, across our Nation.

As you know, Section 215 of Fair and Accurate Credit Transactions Act of 2003 required the Federal Trade Commission (FTC) to complete a study regarding the potential disparate impact credit scoring for insurance purposes has on protected classes of consumers no later than 2 year after enactment. The study is still pending. In your written testimony, you raised concerns that the data the FTC has chosen to use for its analysis comes from an insurance industry-sponsored study that cannot be independently verified for bias or accuracy. You argue that it is likely that the study will offer an unreliable description of insurance credit scoring and its alternatives. In brief, how should the FTC have designed its study to ensure that there is no bias in its design and the information's accuracy could be independent verified?

Answer. The FTC should obtain data directly from insurers and the requested data should be driven by the analysis necessary to satisfy the requirements of the Section 215 study. The FTC has reversed the process—its study is based upon the data the industry is willing to provide. It is unreasonable for the FTC to rely upon data the industry is willing to provide when the industry has a clear interest in the outcome of the study and when the industry can bias the study by providing biased data—biased in terms of what data are provided or biased in terms of incorrect or erroneous data. Attachment 1 is a letter which describes our concern with the FTC approach and our suggestions for what they should have done.

(All attachments are retained in Committee files.)

*Question 2.* Are insurance scoring models treated as confidential proprietary information under many state laws? What percent of property and casualty insurers use credit scores as part of their underwriting decisions?

Answer. Most states treat the insurance scoring models as non-public information. Texas, Virginia and Connecticut are among the states which make the models available to the public. The overwhelming majority of insurers—over 90 percent as measured by market share—use consumer credit information for either underwriting (decision to offer or decline insurance), tier rating (which base rate level or rating tier to assign a consumer to) and rating (as a discount or surcharge off the base rate). More important, insurers' use of credit information has great weight, or impact, on the premiums consumers pay. For auto insurance, the most important factors determining premium are credit history, prior liability limits and prior insurance. The Michigan and Texas Departments publish lists of insurers using credit information on their respective websites.<sup>1</sup>

*Question 2a.* How complex is the model that produces an insurance score? Typically what factors are included? Typically, how heavily is an individual's insurance score weighted by his or her credit score? Has the relative weighting changed over time? Who has the authority to ensure that prohibited factors are not included in insurance score models?

Answer. The models range from relatively simple—a dozen or so factors—to quite complex—several dozen factors. Attached are examples of eight credit scoring models.<sup>2</sup> Attachments 2i and 2j show a Summary of Major Factors and a study of the impact of these factors on pricing of insurance. What is striking about the models is how few of the factors related to payment history and how many relate to economic status and other behaviors not relevant to payment history.

An insurance score is based on information in the consumer's credit history but is not the same as the consumer's lending credit score. Insurance scoring has taken

<sup>1</sup> Links to TX and MI list of insurers using scoring models: <http://www.tdi.state.tx.us/company/creduse.html>; [http://www.michigan.gov/cis/0,1607,7-154-10555\\_12902\\_15784-111965\\_00.html](http://www.michigan.gov/cis/0,1607,7-154-10555_12902_15784-111965_00.html).

<sup>2</sup> Attachment 2a. ChoicePoint, 2b. State Farm, 2c. Met Life, 2d. AIG, 2e. Met Gen, 2f. Progressive, 2g. Allstate, 2h. Hartford.

on greater importance over time in determining a consumer's premium for both auto and homeowners insurance. State insurance regulators are charged with ensuring prohibited factors are not included. However, most state laws are based on the National Conference of Insurance Legislators' model law, which provide little consumer protection in terms of prohibited factors in the scoring models. There is no need to use race as a factor, for example, because other permissible factors are very predictive of race.

*Question 2b.* Are some insurers including factors such as education and occupation as part of their insurance score? Can education and occupation be considered proxies for prohibited factors? If insurers do include such factors in its proprietary scoring model, and the model is kept confidential under the law of the State in which the insurer is licensed to operate, would there be any opportunity for public disclosure? If not, should there be public disclosure that insurers are using such factors, particularly if it results in an adverse decision for the applicant or current policyholder?

Answer. A pure insurance score is based solely on information in the consumer's credit history. Some insurers are developing a scoring system for tier placement that combines credit history (or pure insurance score) with other factors, such as prior liability limits, prior insurance, education, occupation and other factors, typically related to economic status.

There is generally no opportunity for public disclosure. A few states require filing of underwriting and tier placement rules—Michigan, Florida and Texas are examples—but consumers are generally in the dark about what factors insurers consider in setting premiums. In theory, consumers should learn about certain factors through an adverse action notification pursuant to the Fair Credit Reporting Act. However, these notices are limited to adverse actions resulting from insurers' use of information from credit bureaus (also known as consumer reporting agencies). However, even this consumer protection has been undermined by insurer and credit bureau practices. Insurers claim they do not need to send an adverse action notice to new business applicants even if the consumer received a high premium because of credit information. In addition, even when an adverse action notice is provided, the reasons provided by insurers/credit bureaus are so generic that they completely fail to inform consumers. Attached are some "reason codes." Improved disclosure is vital. See the Center for Economic Justice's ("CEJ") comments regarding disclosure to the Washington Insurance Commissioner (Attachment 2k).

*Question 3.* Do you believe that Congress should look at restricting the use of credit scoring in insurance similar to what Washington State has done or should it prohibit the use of credit scoring in insurance entirely? Are there some States that currently prohibit the use of credit scores in insurance for its lines of personal insurance?

Answer. Congress should prohibit the use of consumer credit information as the practice is inherently unfair, discriminates against low-income and minority consumers and is arbitrary in practice. Attachment 3 is a report of CEJ which gives you detailed discussion of these issues.

*Question 4.* Some insurers argue that there is a correlation between poor credit histories and the likelihood of filing a homeowner or auto insurance claim. And as a result of using the predictive value of credit scores to fine tune the rates that it can offer its customers, insurers can charge higher premiums for riskier customers and better rates to customers with good scores, instead of spreading the risk equally across its customer base. To the best of your knowledge, is there evidence of a causal relationship between an individual being late on mortgage payments or credit card bills and a higher risk for filing a claim under a homeowners or auto insurance policy?

Answer. There is a "correlation" between credit scores and insurance claims, but it is a spurious correlation, meaning that credit scores are simply a proxy for some other factor that is truly causative of insurance claims. For example, if the racially discriminatory impact of credit scores was removed, we believe credit scores would no longer correlate to insurance claims.

Credit scoring classifications raise prices for the poor and minorities. Insurers fought to keep Florida from adopting a regulation that would have simply made it improper to use a class that the insurer could not certify did not have a disparate impact on prohibited classes of people.

Before the use of credit scores became widespread, insurer classifications were transparent, with the data in insurers' rate filings showing any correlation. Just as important, the traditional segmentation of classes of consumers who paid different rates was predicated upon a legitimate thesis that was later tested and confirmed as data became available. For example, the thesis for charging higher rates for those

with poor driving records would be something like “By demonstrating poor driving behavior in the past, consumers who have had accidents and received tickets, are likely to be poor drivers in the future.” The data confirm this particular thesis. But there is no comparable legitimate thesis for the use of credit scoring to set rates, just a data-mined “correlation” that may not even be valid and which is not available to the public to confirm.

What is absolutely clear is that the insurers’ explanation for a relationship between credit scores and insurance claims is without merit. Insurers argue that a good credit history leads to a good credit score, a good credit score probably means a consumer is fiscally responsible and a fiscally responsible consumer is likely to a good manager of other risks. This argument fails at every point. A good credit history does not necessarily equate to a good credit score as the scoring models penalize consumers who:

- live in low-income communities
- are more likely to experience an unexpected economic or medical emergency
- whose credit information in a particular credit bureau is incomplete
- who shops around for the best deals
- who doesn’t use credit very much

Should a victim of a hurricane, an earthquake or a job layoff due to outsourcing be charged more for insurance because of events such as these? Should low-income people, who tend to live paycheck to paycheck, be penalized for falling ill and falling a bit behind on credit card payments? Are people in these situations really irresponsible? What makes them worse drivers or homeowners when tragedy strikes?

*Question 5.* In some states, insurance commissioners are elected and, in some states, they are appointed. From the perspective of protecting consumer’s interests, does it make a difference in how an insurance commissioner enters his or her office?

Answer. Elected commissioners are generally more responsive to consumer needs than appointed commissioners. An extraordinary number of appointed commissioners come from the insurance industry prior to becoming commissioner and return to industry after serving, often for a year or two, as commissioner. This is not the case with elected commissioners. But there is a caveat regarding elected commissioners that I must raise. We have seen some very anti-consumer elected commissioners who use insurance industry money to get elected. The best system would be elected commissioners with solid campaign finance rules that reduced or eliminated contributions from the regulated parties.