Consumer Federation of America

STATEMENT OF

J. ROBERT HUNTER, DIRECTOR OF INSURANCE

BEFORE THE EXECUTIVE COMMITTEE OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

"PROPOSED MODEL LANGUAGE REGARDING PRODUCER DISCLOSURES"

DECEMBER 4, 2004

Once again, the regulators are playing catch-up to others who find the problems that exist in the insurance marketplace. Frequently, as in the serious market conduct abuses of the largest life insurers a decade ago, it is attorneys that bring the abuses to light. This time it is Attorney General Spitzer that brings us to the table for regulatory reform today.

I encourage my friends at the NAIC to not shirk from doing all that is needed to reform producer compensation. My message today is simple, "Do not limit your review."

First, do not limit your review to brokers. Your draft disclosure relates to "producers" and that is the right scope. Insurance is not a fully competitive business. Attached is a fact sheet explaining why insurance is not as subject to normal competitive pressures as most other businesses. The reasons include the complexity of the product (a complicated legal document few understand), and the need to assess the financial soundness of the insurer and service quality sometimes years before a claim is filed. Insurance pricing and underwriting mechanisms are also exceedingly complex. Moreover, some consumers will stay with the same insurer, even if they know they are paying too much, for fear of having to file a claim early on with a new insurance company. Indeed, underwriting, the ability of an insurer to say "no" at the end of a long shopping effort, is an extremely unusual aspect of insurance compared to normal products.

The complexity of the insurance marketplace and the reliance of many consumers on agents or brokers as a result leaves millions vulnerable to sharp sales tactics. Many unsuitable policies are sold, such as credit insurance policies, whole life plans for children and singles who do not need the coverage, air travel life insurance, cancer insurance and other inappropriate policies.

The upshot is that many consumers pay too much for insurance. High-priced insurers often maintain significant market share, as people frequently do not shop for insurance, placing their fate in the hands of an agent or broker. Consumers we talk to have a strange combination of feelings when it comes to buying insurance: fear and boredom. Many go to a broker or agent and essentially say, "Take me, I'm yours."

Insurers push the idea that you can trust your agent. Nationwide agents are "on your side." Travelers' says in its Yellow Page ad that they have "local independent agents working for you." Other agents are "like a good neighbor" or treat you with "good hands."

Agents must be included in your review and action.

<u>Second, do not limit the review of contingency commissions to commissions intended to "steer" business to an insurer</u>. That must be reviewed, of course. But so must contingencies related to profitability. Your draft rightly does not limit application to only steering contingency commissions.

To consumers, one particular type of contingency commission is especially troubling. Insurers provide agents with a kickback at the end of the year if clients file a low level of claims. If an agent's loss ratio (the percentage of claims dollars paid out in proportion to the amount of premiums paid by buyers) is better than specified levels, the agent can get more money as a year-end bonus. The lower the agent's loss ratio, the higher the bonus the agent receives. This is an obvious incentive for an agent to delay filing a legitimate claim or to improperly advise a consumer not to file it. This must be carefully studied.

<u>Third, do not limit your study only to disclosure of commissions.</u>

A very strong case can be made for simply banning these commissions, rather than disclosing them. RIMS supported such a ban at testimony before the U.S. Senate last month. CFA believes that disclosure may work for the sophisticated buyers who got ripped off by M&M, but less sophisticated buyers might not understand it. CFA supports a ban.

<u>Fourth, do not limit your study to only contingency commissions, but to all commissions.</u>

Rates vary widely among insurance companies for the same insurer. The wide disparity of prices shows weak competition since, in a competitive market, rates cluster near the market leaders. For home insurance in 2003, commissions paid to agents and brokers ranged from 0 percent to over 30 percent of premium. Among the leading writers, United Services Automobile Association (USAA) had a commission of 0 percent; Farmers had a commission of 1 percent, State Farm had a commission of 13 percent and Foremost had a commission of 26 percent. CFA reviews of rates charged in several markets over time show that one insurer could easily charge double the price of another for coverage of the same insured within the same agency. The agent can maximize profit by placing an insured into a higher priced insurer with a higher percentage commission. Some insurers compete for business by high commission, not low price. This is a conflict of interest as much as a contingency commission.

An example of another potential conflict that you should study is similarly named insurance companies. For instance, in Manhattan for the required auto insurance only, a 20-year old could $4,790 from Allstate Indemnity or $2,153 from Allstate Insurance Company. In Buffalo for a Retired person age 69, rate is $1,629 from Allstate Indemnity or $547 from Allstate Insurance. This can be confusing to even sophisticated consumers. An agent or broker for Allstate could get far higher commission income for placing an insured in the higher priced company, another potential conflict, not uncovered by Spitzer…yet! CFA once helped a dean of a law school who had been placed in the high-priced Allstate and did not know it. He qualified for the lower priced company and, when he threatened suit, was paid his back overcharges. This is another form of conflict of interest.

<u>Finally, do not limit your study to disclosure of just commissions but to all elements of the insurance product.</u>

For 20 years, consumer advocates have called for disclosure similar to the energy efficiency ranking you see when shopping for a refrigerator. This disclosure shows, for example, that a particular unit uses 1000 BTUs, and the average for models like this is 800 BTUs. People understand right away that this is an inefficient refrigerator. CFA would suggest a point-of-sale disclosure of insurance policy value. The disclosure would show the expected payouts per dollar of premium; how much for claims, commissions, overhead, profit and so forth. Commissions could be split into regular commissions and contingent commissions, if you do not ban such commissions. Actuaries know these figures because they are used to set rates. Right next to the various figures would be displayed the same information for the overall industry. This information is also readily available from sources such as the NAIC and A.M. Best & Co. Consumers could focus upon the part of the premium expected to be paid out in losses. This is known as the "loss ratio." So, if the policy a consumer was considering was expected to pay out 50¢ per $1.00 in claims but the industry average were 70¢, the consumer would know that it was a bad deal, an "inefficient" (costly) deal.

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.