



**Comments of the Center for Economic Justice
to the NAIC Big Data Working Group
on the Lawrence Powell Paper**

April 8, 2017

We will only comment briefly on the Dr. Powell paper because it is clearly paid advocacy on behalf of the PCI agenda with a pseudo-academic veneer. The paper consists of erroneous economic argument and massively-broad, fact-free generalizations. We identify just a few of the problems and urge the working group to move quickly to its work plan without spending any more time on the false choices presented by Dr. Powell.

Dr. Powell asserts that the current regulatory framework works just fine and is completely adequate for any Big Data issues that may arise. He bases this assessment on his claim that insurance markets are competitive and in a competitive market regulation is not needed. He states:

Regulation is only appropriate when markets do not work as they should. When markets work well, regulation is neither necessary, nor beneficial for anyone. Competition is the primary indicator of market quality. When markets are competitive, consumers are treated fairly and prices reflect cost of production and a fair profit.

Since he claims insurance markets are competitive, existing regulations and consumer protections – like prohibitions against unfair discrimination, requirements for fair claims settlement and prohibitions against unfair trade practices – are not needed. Of course, this is a silly argument. First, insurance, like almost any market for a product or service, requires ground rules for the market to work. Second, insurance is unlike other product markets in important ways for evaluating whether competition exists and whether regulation is needed to promote competitive markets.

Unlike other consumer products, insurance is not a tangible good acquired and used at purchase, but a promise for future benefits if catastrophic events occur in the future. As such, it is extremely difficult for consumers to evaluate the product they are purchasing until that time in the future when they actually need to use the product. The nature of insurance limits normal competition because consumers have far less information about the product than the sellers.

Second, much insurance is a required purchase – property and flood insurance required for mortgage loans and vehicle insurance required by state law and for vehicle loans. This requirement to purchase is also a departure from other product markets and limits competition.

Third, insurance prices are required to be cost-based to both ensure financial solvency of insurers to pay claims down the road and to avoid intentional or unintentional discrimination based on arbitrary pricing. This requirement for cost-based pricing distinguishes insurance from other product markets and, in turn, requires a set of regulatory structures not found or needed in other product markets.

Fourth, consumers are barred from challenging insurer pricing because of the Filed Rate Doctrine. Consequently, consumers have to rely upon regulators to ensure insurance prices are not unfairly discriminatory and cannot challenge insurers directly.

Dr. Powell's discussion of insurance markets and competition ignores these important distinctions between insurance and other product markets. As a result, his analysis is fundamentally flawed.

Dr. Powell's discussion of competition is flawed in other ways. He cites advertising by insurers as evidence of competition. His error, of course, is that competition among insurers does not equate to a competitive market in which consumers have market power to discipline insurers. In fact, unlike other product markets, consumers have virtually no information about the performance of insurers – how likely an insurer is to litigate a claim or deny a claim or how long an insurer will take to pay a claim. This is in stark contrast to other product markets. For example, the publication of information about vehicle safety performance empowers consumers in the auto marketplace to force auto manufacturers to develop products with improved auto safety and gas mileage.

Dr. Powell's discussion of competition is further flawed because he relies prominently on the number of consumer complaints as a measure of competition. He argues that the relatively small number of complaints means consumers are satisfied and markets are competitive. In general, consumer complaints are not dispositive about competition in markets or the presence or absence of seller abuses in large part because consumers don't know how or where to complain. This is even truer in the insurance world, because we don't even see the total number of complaints, only confirmed complaints. So complaints about opaque Big Data practices would

not be made because insurers don't disclose the practices to consumers. Complaints arising because the product or marketing was deceptive would also not show up because the complaint against the insurer would not be "confirmed."

Dr. Powell's discussion of competition is fatally flawed because he relies largely upon measures of competition used for the evaluation of mergers. The Department of Justice and the Federal Trade Commission have developed procedures for evaluating whether mergers will lead to a reduction in competition. These measures include market concentration, for example.

Dr. Powell's reliance on these measures for evaluating the competitive impacts of mergers is not relevant for evaluating the need for regulation. Stated differently, the measures used by the DOJ to evaluate a merger may indicate that the merger will or will not reduce competition, but have nothing to say about whether the markets require regulation to create or promote competition or to protect consumers.

Beyond using an inappropriate methodology to evaluate the issue of whether regulation is needed in insurance markets generally or in an era of Big Data specifically, Dr. Powell doesn't even apply the incorrect methodology correctly. One of the fundamental issues with competitive analysis for mergers is to define the relevant market or markets to be affected. For example, when the DOJ objects to and/or seeks to restructure certain proposed mergers, the DOJ looks at particular markets. So, when airlines seek to merge or create joint ventures, the DOJ doesn't look at the entire US or the world, but at specific markets like, in the case of Delta-Aeromexico joint venture, the market for flights between Mexico City and New York.

In evaluating insurance markets, particularly in an era of Big Data when insurers can segment consumers and locations to individual levels, the relevant market is not the entire country or even entire states, but smaller geographic areas in which many or most insurers do not operate or are not actively writing. Dr. Powell's analysis does not define correctly define the relevant markets and does not examine the relevant markets.

Yet another error in the Dr. Powell analysis is his assessment of profitability. He compares insurance industry average return on net worth to that of other industries. His analysis is fatally flawed because the insurance industry returns are skewed downward by the large market share of mutual insurance companies who do not seek returns for investors and do not seek capital from investors. His analysis also fails to consider that return on investment is related to risk – where risk is understood as variability in returns relative to the market as a whole.

Dr. Powell's report is replete with broad, fact-free generalizations. Examples include his claim that concern over transparency and fairness in pricing is unwarranted because regulators can ask for whatever information they want, because Big Data algorithms are objective and because more refined pricing is always better.

These claims are easily shown to be false. First, with Big Data, regulators are now put in the position of relying completely on insurer representations about their pricing practices. Unlike historical industry pricing based on traditional actuarial analysis when regulators could actually get the data relied upon by insurers and replicate the analysis, today, regulators do not have the ability or resources to obtain the underlying data and replicate insurer analyses to determine if the insurer representations are accurate. Moreover, regulators do not collect data on market outcomes to determine if the market outcomes are consistent with industry representations.

Second, there have been numerous studies and reports by folks with actual expertise in Big Data algorithms documenting the potential and actual discrimination against particular classes of consumers from Big Data algorithms. In one example among many, Cathie O'Neill's *Weapons of Math Destruction* documents a number of examples in which biased data – data in which discrimination against minorities was baked in – resulted in biased algorithm outcomes. To use the phrasing from the Insurance Information Institute, Dr. Powell makes a rookie mistake in his broad claim about objective algorithms.

Third, Dr. Powell repeats the industry mantra that ever more refined risk classification is better because price is better matched to risk and insurer will write more business. Again, this claim is overbroad and false. While there is clearly a benefit to some risk classification – that which transparently communicates risk to consumers and rewards consumers for less risky behavior – there is clearly a limit beyond which more refined pricing has no impact on insurers' willingness to offer coverage and, in fact, leads to less availability as insurers can restrict coverage to preferred customers. This fact was expressed by Allstate CEO Ed Liddy over ten years ago in comments to investment analysts:

Tiered pricing helps us attract higher lifetime value customers who buy more products and stay with us for a longer period of time. That's Nirvana for an insurance company.

Tiered pricing has several very good, very positive effects on our business. It enables us to attract really high quality customers to our book of business.

The key, of course, is if 23% or 20% of the American public shops, some will shop every six months in order to save a buck on a six-month auto policy. That's not exactly the kind of customer that we want.

Those comments were at the dawn of Big Data use by insurers. Today, the number of price levels has grown exponentially and the transparency of pricing to consumers has decreased exponentially. The result is greater market power for insurers versus consumers and a reduction in consumer market power and, yes, competition.

Dr. Powell lists a number of positive developments with Big Data. As stated many times, we believe insurers' use of Big Data holds great promise for empowering consumers and promoting more competitive markets, improving availability and affordability of critical insurance products for consumers and enhancing the interaction between insurers and consumers. But, along with the great promise of Big Data come a number of concerns which can and should be addressed to ensure the promise of Big Data becomes a reality. Consumer protection and insurer accountability to consumers over insurers' use of Big Data is compatible with innovation and competition.

Dr. Powell presents a false dichotomy – consumer benefits or regulation. In reality, the choice is not remotely between Big Data or nothing. For example, telematics can clearly be beneficial to consumers and insurers by empowering consumers for loss mitigation, but such benefits are compatible with consumer protections about disclosure, consent, data ownership and data access.

In summary, Dr. Powell's paper provides no assistance to the working group and we urge the working group to move on to its fact-based work plan.