Comments of the Center for Economic Justice

to the California Department of Insurance Regarding

RH 2012-0013
Lender-Placed Insurance and Amendments to Commodity and Specialty Insurance Classifications

October 25, 2012

The Center for Economic Justice (CEJ) offers the following comments in response to the Department's request of September 28, 2012 regarding lender-placed insurance (LPI) and amendments to commodity and specialty insurance classifications.

LPI is a consumer credit-related insurance product. Consumer credit-related insurance ("credit insurance") in insurance sold in connection with a consumer loan and which generally serves to protect the creditor's interest. Credit insurance is distinguished from trade credit insurance and other types of commercial products which guarantee payments among trade partners. Consumer credit insurance includes credit life, credit disability, credit involuntary unemployment, credit family leave and various types of credit property insurance, such as credit personal property, credit GAP and, of course, LPI.

Credit insurance has historically been regulated in a different manner than other types of insurance because of the unique characteristics of credit-related insurance products and markets. The New York Department of Financial Services Regulation 27A describes the reverse-competitive markets of consumer credit-related insurance and vulnerabilities of consumers in such markets.

> *In the marketing of credit insurance, the inferior bargaining position of the debtor creates a "captive market" in which, without appropriate regulation of such insurance, the creditor can dictate the choice of coverages, premium rates, insurer and agent, with such undesirable consequences as: excessive coverage (both as to amount and duration); excessive charges (including payment for nonessential items concealed as unidentifiable extra charges under the heading of insurance); failure to inform debtors of the existence and character of their credit insurance and the charges therefore, and consequent avoidance of the protection provided the debtor by such coverage.*
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> *In the absence of regulation, premium rates and compensation for credit insurance tend to be set at levels determined by the rate of return desired by the creditor in the form of dividends or retrospective rate refunds, commissions, fee or other allowances, instead of on the basis of reasonable cost. Such "reverse competition," unless properly controlled, results in insurance charges to debtors that are unreasonably high in relation to the benefits provided to them.* (New York State Insurance Department Regulation 27A -- 11NYCCR 185)

The vulnerability of consumers to credit insurance abuses is exacerbated with LPI because, unlike other types of credit insurance in which the consumer generally must affirmatively elect to purchase the credit insurance, LPI is forced on consumers with no affirmative acceptance by the consumer at the time of placement. The vulnerability of consumers in credit insurance markets, generally, and in LPI markets, specifically, is demonstrated by excessive rates, low loss ratios and unreasonable creditor compensation.

Because of the unique characteristics of credit insurance markets, credit insurance is generally regulated in a different manner from other types of insurance. In California, there is a separate regulatory framework for credit insurance set out in **California Insurance Code §779.36.** The statute requires the Commissioner to establish prima facie rates based on minimum loss ratios. The force-placed nature of LPI means that additional consumer protections are needed for LPI even beyond those for voluntary credit insurance. Creditors with any type of financial interest in LPI (other than the coverage provided), such as commissions, captive reinsurance profits or any other type of direct or indirect consideration have a conflict of interest because the creditor (or its servicer) are in a position to dictate the terms of required voluntary insurance, determine when such voluntary insurance is unacceptable and dictate the terms of placement.

An examination of reverse competition in LPI markets demonstrates why a regulatory framework different from that used for other types of insurance is needed. With LPI, the lender/servicer holds the market power, but does not ultimately pay for the insurance – the borrower pays or, in the event of borrower default, the owner of the mortgage pays the premium. The lender/servicer has market power because the insurer cannot sell insurance without a referral from, sale by, or placement by the lender. Insurers therefore compete by bidding up considerations to the servicer for the business. With LPI, these considerations take the form of commissions to servicer-affiliated agents even though no traditional agent activity is required; captive reinsurance agreements in which LPI insurer shares excess profits with servicer affiliated insurer – arrangements which provide no benefit to borrower but increases costs by size of administrative expenses of reinsurance; marketing allowances even though no marketing is required; and free or subsidized services unrelated to the provision of LPI, including free or below-cost insurance tracking.

The key “take away” from the recognition and acknowledgement of reverse competition in credit insurance, including LPI, markets is that expenses are inflated beyond the reasonable amounts necessary to provide the product and, most important, <u>the fact that an LPI insurer actually incurred expenses – as reported in the IEE of annual statement – does not mean those expenses are reasonable expenses for the provision of LPI insurance.</u> Expenses reported in the annual statement of the largest writer of LPI, American Security Insurance Company, for example, include expenses for a variety of hazard outsourcing activities unrelated to the provision of LPI, including insurance tracking.

Attached to these comments, please find CEJ’s testimony on an LPI rate filing in Florida, which provides a detailed discussion of the LPI markets and the reasonableness of LPI expenses reported in statutory annual statements.

With this background, it is clear that the use of either the standard commodity or specialty rate regulatory frameworks is problematic for LPI.

Categorizing credit and LPI as specialty and applying the "most sound actuarial method" suffers from at least two major problems. The first is that standard actuarial methods do not include provisions to identify and exclude unreasonable expenses during the ratemaking process. Our review of numerous LP rate filings indicate that LPI insurers rely on annual statement data or provisions approved in other LPI filings. It has been common for LPI insurers to include provisions for commissions, other acquisition and general administrative expense totaling 30%. Yet, as the attached Florida testimony demonstrates, a reasonable provision for these expense categories is around 10%.

The second problem with applying the "most sound actuarial method" to credit insurance, generally, and to LPI, specifically, is the spectacular and systematic failure in projecting expected claims. From 2004 to 2011, California LPI insurers earned over $2.5 billion in premium based on rate filings with expected loss ratios of 52.5% or higher. In fact, the actual LPI loss ratios, as reported in the Credit Insurance Experience Exhibit of the statutory annual statement, were consistently nowhere near the expected loss ratio.

2004	29.7%
2005	35.9%
2006	35.6%
2007	18.9%
2008	18.4%
2009	19.7%
2010	10.8%
2011	21.3%
2004-2011	21.2%

Putting aside the fact that a permissible loss ratio of 52.5% is far too low and reflects the padding of rates to include unreasonable expenses, standard actuarial methods produced errors in projected claims by a factor of 250% (.525/.212). Borrowers charged for LPI were overcharged by 60% based on the too-low filed expected loss ratio of of 52.5%. In fact, borrowers charged for LPI were overcharged by an even greater percentage when a reasonable permissible loss ratio is used. LPI insurers and mortgage servicers, through various profit-sharing mechanisms, profited immensely from excessive LPI rates based on standard actuarial methods.

The methodology for commodity lines of insurance is also problematic for credit insurance generally and LPI specifically. For LPI, the first problem involves the line of insurance to utilize for applying the efficiency standard. There is no annual statement line of insurance for LPI. And the lines of insurance in which LPI has been filed – fire and allied lines – have expense characteristics which are not comparable to those of LPI. Fire or Allied lines are not applicable for LPI because those are individually underwritten policies and include residential and commercial properties. The credit line is inapplicable because it includes unrelated types of insurance, like trade credit insurance.

The second problem with applying the commodity methodology to LPI is that the efficiency standard has limited relevance in a reverse competitive market. The concept of the efficiency standard is predicated on competitive market forces pushing insurers to spend only those expenses necessary. It is intended to force inefficient insurers to become more efficient; not to weed out inflated expenses resulting from reverse competition.

There is no annual statement line for LPI or any line applicable for LPI for purposes of the efficiency standard. Even if there were a separate line of business for LPI with data specific to LPI experience, it would still be useless for the standard methodology because actual expenses incurred in a reverse competitive market are inflated for all carriers – there is no competitive mechanism leading to efficiency. Use of the standard methodology is further unrealistic because of the limited number of insurers, that two insurers groups experience will represent nearly the entire LPI expense experience. If the commodity methodology were used for LPI, it would be necessary for the Commissioner to establish an efficiency standard based on reasonable expenses for LPI as opposed to an average of some amounts reported in a particular line or lines of insurance within the Insurance Expense Exhibit.

The proper rate regulatory treatment for LPI is the same as that for other credit-related insurance – maximum rates based on minimum loss ratios. This could be accomplished in one of at least two ways. The first approach is to establish a regulation pursuant to CIC **§779.36.** Under this authority, the Commissioner could establish by regulation a minimum loss ratio for LPI. The provisions of such a regulation could include:

- Establishing a maximum expense ratio for all non-claim expenses, including taxes, licenses, fees, commissions, other acquisition expenses and general and administrative.
- Establishing a minimum non-catastrophe loss ratio, including non-cat claims and non-cat claim settlement expenses
- Establishing a catastrophe provision, which includes expected catastrophe losses and/or net costs of catastrophe reinsurance.
- Requiring an annual evaluation of non-cat losses and revision of rates if the actual three-year non-cat loss ratio at current rate levels was 5% below the minimum non-cat loss ratio and allowing an increase in rates if the three-year non-cat loss ratio at current rate levels was 5% or more greater than the minimum loss ratio.

For example, if the maximum expense ratio was 15% and the catastrophe provision was 10%, the minimum non-cat loss ratio would be 75%. If, over the most recent three-year period, the insurer's non-cat loss ratio was 69.9% or less, the insurer would be required to reduce LPI rates. Such a reduction would be required even if the actual loss ratio – including catastrophe losses – were greater than 75%. Conversely, an insurer could seek higher rates if its overall loss ratio were 82% if there were no cat losses during the period.

In conclusion, CIC 779.36 specifically addresses credit property. The NAIC has identified LPI as a type of credit –related insurance whose experience is reported on the credit property page of the Credit Insurance Experience Exhibit. In the alternative, if the Commissioner wished to utilize the commodity methodology for LPI, such an approach would require establishing a separate line of insurance for LPI with a separate efficiency standard based on reasonable expense provisions established by the Commissioner in recognition of reverse competition in LPI markets.

Traditional ratemaking methodologies fail for LPI because of inflated LPI expenses. LPI expenses are inflated because mortgage servicer receive a significant portion of the premium – directly or indirectly – by virtue of the servicer's market position to direct business to the LPI insurer. These expenses should clearly be prohibited. A mortgage servicer should be prohibited from receiving any consideration whatsoever, directly or indirectly, from the premiums paid for LPI other than coverage provided through the LPI. Such a prohibition on LPI considerations to the servicer is reasonable and necessary because once the servicer has a financial interest in the placement of LPI, the servicer has an insurmountable conflict of interest that disadvantages the borrower. The conflict of interest is severe because the lender or servicer has the authority to dictate the types and amounts of insurance coverage required. The conflict arises when the servicer has a financial interest in the placement of LPI and is in a position to profit from its ability to dictate the terms upon which that LPI is placed. It is essential to eliminate this conflict of interest because the placement of excessively priced LPI can be a devastating financial burden on borrowers. This conflict can be addressed by insurance regulators by prohibiting the inclusion of any expenses in LPI rates for any consideration to the servicer – cash or free or below-market cost services.