



## **Consumer Federation of America**

1620 I Street, N.W., Suite 200 \* Washington, DC 20006

### **TESTIMONY OF J. ROBERT HUNTER<sup>1</sup>, DIRECTOR OF INSURANCE**

#### **JOINT HEARING HELD BY THE PROPERTY AND CASUALTY INSURANCE (C) COMMITTEE AND THE MARKET REGULATION AND CONSUMER AFFAIRS (D) COMMITTEE OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS**

**August 9, 2012**

I appreciate the opportunity to submit this testimony to you today. I am sorry that illness keeps me away from Atlanta today.

The work you are undertaking to address the abuses in force-placed insurance (FPI) is of vital importance to people all over the nation, many of whom are being harmed by astonishingly excessive rates for force-placed coverage.

#### **Background**

Force-placed insurance (FPI) is an insurance policy placed by a lending institution on a borrower's property, when a borrower does not keep his or her hazard insurance in force. The lender is typically the named insured party. The borrower is also usually listed as an "insured" on a force-ordered (FO) policy. The majority of FPI policies are issued when the borrower loses normal insurance due to non-payment of premium.

Lenders use FO insurance to assure continuous coverage on properties. In many instances, lenders use FO insurance as a profit center by collecting commissions from insurers through lender-affiliated agents or brokers or by receiving below-cost or free services (such as tracking of loans) from insurers, and/or using "fronting" primary insurers to direct the coverage in whole or in part to lender-affiliated captive reinsurers.

Due to the recent tough economic and housing situation, many more home hazard, flood and wind insurance policies have become force-placed. The data on Balboa Insurance Company homes insured in Florida shows only 3,598 homes insured in 2005, but 319,926 homes insured in 2010.

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A major problem with the use of FPI insurance is "reverse competition." Reverse competition is a market structure in which insurers compete for the lenders' business by providing financial considerations to the lender, including commissions, subsidized services, and other things of value. These expenses are included in the premiums charged to borrowers, which significantly drives up the price. In other words, reverse competition is a market condition that drives up prices to the consumers, as opposed to normal competition, which drives down prices to consumers. Market forces do not discipline insurers to remove unreasonable expenses when reverse competition exists.

Normal competition exists when the purchaser of insurance is the insured party who pays for the coverage. He or she therefore shops for the lowest possible price. The competition is reversed when the "buyer" (lender) is not the ultimate payer of the premium but, instead, has a financial interest in the insurance through commissions or other financial benefits. In this case, the lender, who is not the ultimate payer, has an incentive to seek higher cost insurers that offer bigger kickbacks and benefits, rather than the lowest cost option. This financial incentive may explain why low-cost options for force-ordered borrowers -- such as establishing an escrow account and paying the voluntary premium, in the case of non-escrowed insureds being terminated for non-payment -- does not appear to be a high priority for lenders<sup>2</sup>.

### **FPI Rates are Excessive**

Reverse competition manifests itself in FPI through the payment of commissions to agents or brokers affiliated with the lender or servicer, the provision of below-cost or free tracking services provided by the FPI insurer to the lender, and through FPI carriers that reinsure FPI insurance (either in whole or in part) with captive reinsurers owned by lenders. Thus, FPI rates are much higher than normal insurance rates.

In most states there have been no rate filings for FPI insurance for many years. The two major writers of FPI, Assurant and QBE/Balboa (who write over 99 percent of the business nationally) appear to charge the same or similar rates in most states. Data demonstrating the excessiveness of FPI prices for Praetorian (QBE) in Florida, where a 2012 rate filing was available, is shown in CFA's analysis of their May 4, 2012 rate filing. Our analysis showed that these rates are excessive by at least 44.1 percent and likely much more than that (See Appendix 1).

Reverse competition abuses fall into the cracks between insurance and banking regulation. Looked at purely from the typical insurance regulator's perspective over recent decades, FPI is commercial insurance between a sophisticated seller (the FPI insurance company) and a sophisticated buyer (the lender or servicer.) In addition, the expenses that occur because of reverse competition may be unjustifiably high, but they are real. Commissions paid to agents (usually for little or no work) below-cost tracking costs can be documented, and reinsurance arrangements with lender affiliates do exist.

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<sup>2</sup> Although, once the insurance is force-placed, the lender often then sets up an escrow account to pay the premium and bill the cost to the borrower on a monthly basis. In the case of non-payment of premium, the most usual cause for a lapse in normal coverage, there seems no reason why the lender could not have simply set up the escrow account then and kept that much lower cost policy in place.

Several years ago, when most of the rates being used to sell FPI were filed, insurance regulators looked at these facts and almost always approved the rates to be charged *to the lender*. In the years since, until very recently, insurance regulators only performed a superficial analysis to see where those expenses were flowing from. Hearings in California, New York and Florida over the last few months have finally started to uncover what is really going on in FPI pricing.

Further, insurance regulators did not look beyond the insurer/buyer transaction to assess the impact on others who might be actually paying the bill, such as the borrowers who pay for FPI. This lack of attention to consumer impact is also true for automobile FPI, title insurance and various forms of credit insurance, where reverse competition is rampant. Individual consumers are significantly harmed by these cozy reverse competition arrangements.

Banking regulators appear to have done little to control these abuses either. They often see this as an insurance issue; in other words, somebody else's problem. Besides, what could be better for safety and soundness than the huge profits FPI generates for lenders?

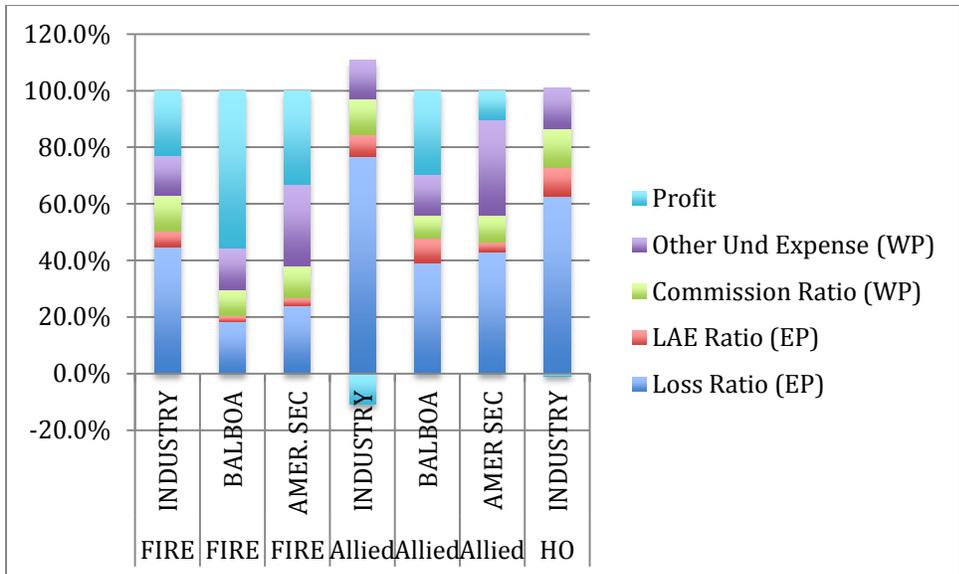
### **Insurer/Service Provider Explanations for High Rates are not Valid**

Insurers have justified excessive FPI rates on two basic grounds:

1. Insurers do not underwrite FPI, and, therefore, cannot adequately consider the insurance risk of each borrower, and
2. Insurance departments approve all FPI rates.

Data demonstrates that the lack of underwriting only explains, at most, a small fraction of the higher FPI prices. Some borrowers do not have home insurance – and must be force placed – because they are higher risk and cannot get the coverage. However, most borrowers become force-placed because of non-payment of premiums, not higher insurance risk.

Consider this chart showing how each premium dollar for FPI and normal home insurance is allocated:



Data underlying this chart are shown in Appendix 2. “HO” is Homeowners Insurance.

Note that the loss ratios (the part of the dollar used up by losses) are much lower for Balboa and American Security, which sell FPI, than for the home insurance industry overall. If an insured can’t pay his or her homeowner’s insurance premium and is thus force-placed, the expected payouts in losses per-dollar-of-premium drops sharply from 62.7 percent for the average industry homeowners’ policy to 24.0 percent for American Security and 18.3 percent for Balboa.

To put these ratios into perspective, if a homeowner being force-placed was paying a rate of \$1,000 for the average industry homeowners’ policy, the insured’s expected losses would be \$627.00. However, in order to cover \$627.00 for claims payouts, American Security would require a premium of \$2,612.50 and Balboa would require \$3,426.23, rather than the average industry homeowner’s policy charge of \$1,000, to cover that payout.

Lack of underwriting should also result in much lower acquisition expenses for FPI insurers, since no sales force is required to place the insurance. For this and other reasons, it is unclear if overall FPI rates should legitimately be much different than normal rates, when adjusted to use proper commissions (if any at all are justified), to remove unjustified tracking costs from pricing and to eliminate profit kickbacks through captive reinsurance arrangements. I expect it they would be only marginally – well under five percent – higher if they were properly priced.

The rates charged by FPI insurers to lenders are clearly excessive, despite the fact that the rates were approved by state insurance departments. Analysis has shown that significant portions of the expenses underlying the rates are not legitimate underwriting costs, but rather kickbacks to lenders under “sweetheart deals” where both the lenders and insurers make excessive profits by overcharging force-placed borrowers. Borrowers should not have to pay for expenses unrelated to the insurance risk being covered for that individual. For example, two to three percent of borrowers who are force-placed pay all, or much, of the cost of tracking the entire portfolio of lender loans, including escrowed loans that will not be force-placed for non-payment, and

despite the fact that, in many cases, the cost of tracking has already been paid to the lenders. Further, expenses that are clearly excessive, such as the commissions paid for many force-placed policies, should be controlled. Likewise excessive profits for bank-affiliated reinsurers should be eliminated. In other words, FPI profits flowing to the lender should be excluded from the price charged to the borrowers for FPI<sup>3</sup>. The amount a borrower pays for FPI should be only that which is reasonably necessary to cover the risk, expenses and profit of that individual's insurance.

### **Suggestions for Reform**

#### Eliminate or substantially reduce kickbacks through adoption of a Minimum Loss Ratio.

CFA recommends that the states require a minimum loss ratio (MLR) as the best way to control the adverse consequences to consumers of reverse competition. However, to be meaningful, the MLR must be vigorously enforced. The loss ratios that insurers claimed they would meet in earlier rate filings were never realized. Indeed, as demonstrated above, the actual loss ratio results were often less than half of what the insurers said they would be (see Appendix 2).

Commissions to lender-affiliated agents or brokers are problematic and appear to be falling out of use, as some lenders have recently eliminated them. There is little for an agent or broker to do in a force-placed situation and little need for commissions. Realistically, a fair commission for FPI insurance is well under two percent, using industry norms and considering the higher price of FPI. Even if FPI rates come down to the proper level -- a fraction of today's rates -- it is unlikely that the fair commission rate would reach three to five percent of premiums. Other acquisition and general expenses should also be minimal; perhaps another five percent when tracking costs are not included. A minimum loss ratio of no less than 80 percent seems reasonable as an enforceable standard, in order to remove the adverse effects of reverse competition from FPI insurance.

#### Eliminate or substantially reduce kickbacks through better price regulation

The alternative approach is to allow only reasonable expenses associated with the provision of FPI insurance and prohibit expenses associated with servicing and profits that flow to lenders. Given the existence of reverse competition and the history of low loss ratios and inflated expenses, the burden should be on insurers to demonstrate the legitimacy and reasonableness of expenses. However, this standard is much more difficult to enforce than a MLR, since it requires the insurance department to continually dig beneath expenses and profits to find out where these dollars are flowing. It is possible to do, but very complex. Moreover, it

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<sup>3</sup> Fannie Mae's March 6, 2012 Request for Proposal, "Lender Placed Insurance, Insurance Tracking, Voluntary Insurance Lettering Program," proposes to eliminate costs of commissions, tracking services and any other costs other than the policy premium in FPI rates they reimburse, effectively regulating the price of insurance they pay. Astonishingly, the RFP points out that Fannie Mae is "often paying twice for insurance Tracking services; once via the servicing fee that Fannie Mae pays to Servicers, and again via the Lender Placed Insurance premiums." In other words, the lenders were double dipping on the cost of tracking, the second dip being at the expense of homeowners struggling to make ends meet in tough economic times.

is not a very effective way of countering the reverse competition dynamic that is prevalent in this market place.

### Call immediate rate hearings

I also urge each insurance department to demand immediate rate hearings for all FPI insurance rates, asking the insurers to justify the current rate levels. Through either adoption of a MLR or through more rigorous rate regulation, the FPI prices should be substantially reduced. The NAIC should take the lead in helping states by doing some of the common actuarial work centrally for the states to consider, including a suggested MLR for the states to consider. The state market conduct examiners, actuaries and other experts will have to, for the first time, delve beneath the surface of expenses and affiliate arrangements, such as reinsurance, to determine fair levels of expenses and profits and root out the vestiges of reverse competition abuses. The NAIC market conduct experts can also do some of the common work as a service for states to consider.

### Praetorian Rate Filing

I analyzed the part of the Praetorian (QBE insurers) filing of May 4, 2012 in Florida that was made publicly available (see Appendix 1). The insurer provided data for 2007 to 2010 that showed a loss ratio in Florida of only 4.4 percent, yet they proposed no reduction in rates. Even without being unable to review a significant part of the filing, the CFA analysis showed that rates should be lowered by at least 44.1 percent. When selections currently labeled “trade secret” by the insurers become available, we expect that our recommended reduction will increase significantly.

### Conclusion

For the past 30 years, I have urged the NAIC to protect consumers from lines of insurance suffering from reverse competition, including home FPI. Although the matter has been raised by consumer groups several times, it has taken almost a quarter of a century for the NAIC to even hold a hearing on the subject. Other lines of insurance, including auto FPI, credit insurance and title insurance, also suffer from reverse competition and far too little has been done to these control abusive pricing practices.

While I strongly support the NAIC’s decision to document the pricing practices in home FPI, I hope that you will act soon on the other lines suffering from similar forms of reverse competition. CFA specifically requests that the NAIC hold hearings on title insurance and on credit insurance.

### Appendices

1. Analysis of current FPI rate filings by Praetorian.
2. Insurance statistics for FPI and voluntary home insurance for the last decade.

**REVIEW OF FLORIDA RATE FILING OF PRAETORIAN  
INSURANCE COMPANY (BALBOA AND QBE Specialty)**

Praetorian made a force-placed insurance rate filing in Florida on May 4, 2012. In it, the insurer proposed to charge Balboa's existing rates for both Balboa and QBE. The proposed rates would allegedly represent no change from the Balboa level, while allegedly reducing QBE Specialty insurance rates. The filing claims QBE Specialty rates are 10.5 percent higher than Balboa's, but no support is provided for this claim. For most exhibits, combined QBE Specialty and Balboa experience is provided; the data should be provided separately to evaluate the impact of combining the books of business.

It should be noted that QBE Specialty is a surplus lines carrier. It is unclear how the agent affiliated with QBE Specialty could have complied or can comply today with surplus lines due diligence requirements when other admitted insurers are writing this coverage.

The filing could only be partially reviewed by CFA, since all material related to hurricane CAT pricing, including the charge for reinsurance, is not available to the public because the filer claimed this information as a "trade secret." Partial availability of the data upon which a rate filing is based is a disservice to consumers. At least a process when consumer groups with expertise to examine filings should be implemented so entire filings can be studied.

Using the available material, as discussed below, CFA finds that the rate filing is a massive actuarial overreach. Even assuming that the information provided by the company on hurricane CAT pricing is 100 percent valid, CFA calculated that prices should drop by at least 44.1 percent. When the "trade secret" material is reviewed the reduction is most likely a lot more than 44.1 percent.

Consider this: the actual 2Q 2007 to 2Q 2011 incurred losses and loss adjustment expense (LAE) was \$62,375,524 and the actual earned premium was \$1,399,464,459. This represents a loss ratio of 4.5 percent, which means that less than 5 cents out of every dollar paid in premium went to claimants!

How can a rate filing based on such low payouts conclude that no change in price is needed? It can be done because, as one former insurance commissioner<sup>4</sup> put it, "A rate filing is a few facts and a lot of factors." By applying questionable factors, Praetorian attempts to mislead the Florida Commissioner. Praetorian's distorted calculations indicate a rate decrease of 15.5 percent, which may be akin to Brer Rabbit asking to be tossed into the Briar Patch. Praetorian would probably love to receive only a 15.5 percent decrease given the facts.

The data used in the filing should be reviewed. Data on REO business should be excluded in the calculation of rates to be charged to borrowers. Borrowers should not be required to subsidize

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<sup>4</sup> James Stone of Massachusetts.

bank REO properties. Further, the data should be split between Balboa and QBE to see if the indications are different since QBE’s recent entry into the market might skew the combined data.

Let’s catalogue the impact of Praetorian’s use of improper factors:

### Expense Provisions

Praetorian selected expense provisions (other than hurricane CAT costs) totaling 34.9 percent of premium. They based this number on 15.0 percent paid in commissions, even though, historically, they spent only 4.7 percent on commissions. They also asked for more than they spent on general expense (11.5 percent vs. 9.4 percent). Logically, force-placed insurers incur very low expenses for generating business, since the tracking of the loan delivers the business to the insurer at no cost. So, commissions and other acquisition costs should be well under 5 percent of premium. (CFA allows 5 percent in the rate level calculation below). Praetorian says it needs to jack up commissions because of “expected commissions necessary to acquire new business commensurate with industry standards.” What that means is the industry has, up-to-now, paid kickbacks to bank-affiliated agents and the insurer can’t compete if they do not do the same. This is exactly what regulatory oversight must stop and the Fannie Mae RFP makes clear will not be paid by Fannie.

The large amount of general expenses that Praetorian claims is another kickback area. The cost of tracking loans has been done for free or below-cost by force-placed insurers. These tracking costs in addition to commissions are hopefully ending as a result of the recent decisions by Fannie Mae. The fact that Tracking really represents a double dip for the lenders is a disgrace.

I assume no kickbacks in CFA’s selected expense provisions:

Type	Data	Insurer Selected	CFA Selected	Fixed	Variable
Commissions	4.7%	15.0%	2.6 <sup>5</sup> %	0.0%	2.6%
Other Acq	2.3%	2.4%	2.4%	1.2%	1.2%
General	9.4%	11.5%	5.0%	2.5%	2.5%
Taxes, fees	1.8%	2.3%	2.3%	0.0%	2.3%
Non-CAT profit		3.7%	3.7%	0.0%	3.7%
<b>SUBTOTAL</b>		<b>34.9%</b>	<b>16.0%</b>	<b>3.7%</b>	<b>12.3%</b>
<b>Net Reinsurance Cost (Not analyzed by CFA<sup>6</sup>)</b>			<b>22.3%</b>		

<sup>5</sup> These are extremely generous provisions. For instance, Commissions probably should be zero given the recent pronouncements by Fannie Mae and there is really no need for an agent to “produce” and service business, the tracking does that automatically. General Expense also, with tracking costs removed, should be less than 5 percent.

<sup>6</sup> Because of the “trade secret” claim, CFA could not review these data.

TOTAL	38.3%	12.3%
PERMISSIBLE LOSS AND LAE	61.7%	87.7%

### **Premium Trend**

CFA selected zero premium trend, so premiums are as reported, put on level but with no trend.

The reason Praetorian provided for a negative 3 percent premium trend is that rates may be regulated (“regulatory trends expected to reduce future premium”). The fact that premiums are going to face scrutiny is no reason to allow a negative premium trend. This inappropriately allows an insurer to jack up a rate that they are about to be required to lower. Also, since there was no adjustment to loss trend for anticipated higher deductibles in the future, there should be no adjustment to premium trend for that possible effect.

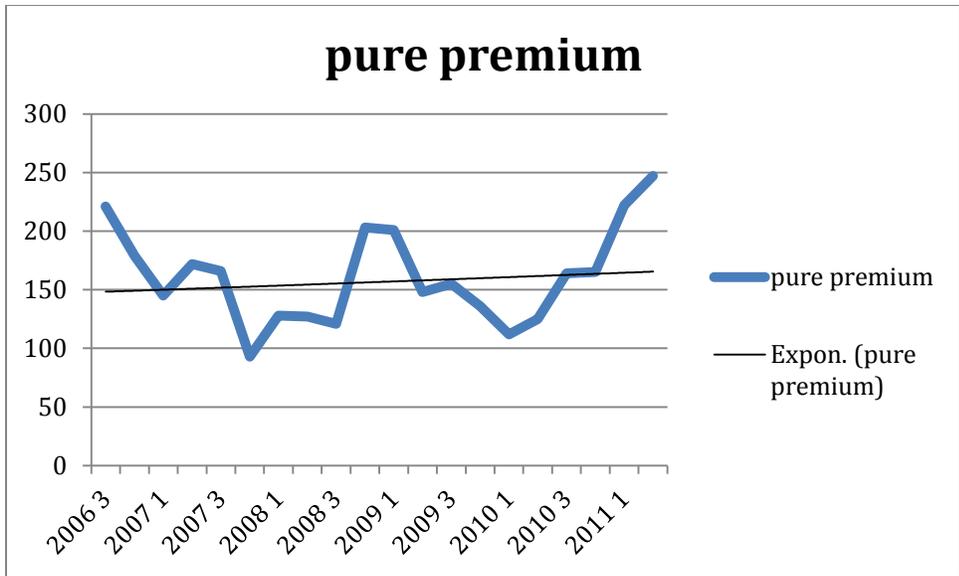
### **Loss Trend**

Praetorian, using very few data points, proposes an astonishing annual pure premium trend of 23.9 percent. I have never, in 40 years of reviewing filings, seen any trend factor like that.

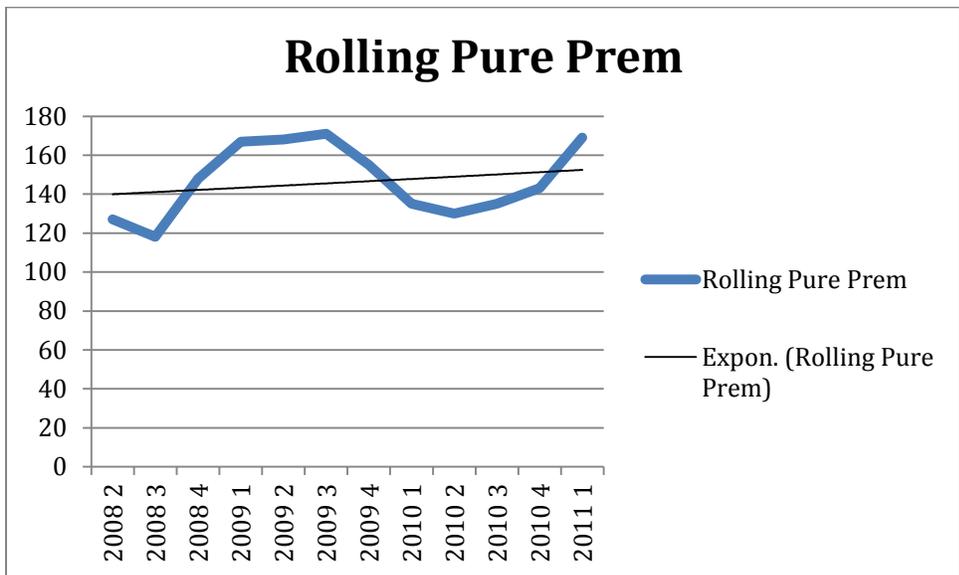
The trend data<sup>7</sup> does show a recent spike in frequency, but that is likely related to recent CATs in early 2011. I looked at all the data and plotted the exponential trend lines. Here it is for the full five years of data reported by Praetorian. The first chart presents the actual pure premium numbers.

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<sup>7</sup> The data are unclear as to whether paid or incurred losses are being used. If paid, the trend is skewed by the growth in exposures followed by flattening exposures and an analysis of that effect is required. If incurred, the impact of reserves must be analyzed. The trend data shows no analysis and we are not even sure what data are used. Separate review of Balboa and QBE experience is particularly important for trend analysis.



And here is the rolling average quarterly data for 12 points (the standard trend format that is used most in rate making):



Both of these lines indicate an annual trend under 5 percent. I have chosen a 5 percent exponential trend. The calculation of the non-CAT trended and developed incurred losses and LAE is:

6/30 Acc Year	Non-CAT Losses Incurred	Loss & LAE Development	Loss Trend	Non-CAT Trended & Dev Loss/LAE
2007	\$3,788,681	1.000	1.390	\$5,266,267
2008	\$5,640,134	1.006	1.324	\$7,512,342

2009	\$9,701,715	1.028	1.261	\$9,973,365
2010	\$19,590,997	1.108	1.201	\$19,590,998
2011	\$23,653,996	1.424	1.144	\$38,533,684

## Rate Level Calculation

Based on the above changes, CFA calculates the proper rate level for FPI for Praetorian as:

Year	Earned Premiums On Level	Incurred Loss/LAE <sup>8</sup> plus non-Hurr	Loss/LAE Ratio w/ non Hurr CAT	Acc Year Weights
2007	\$34,202,657	\$5,549,472	16.2%	5%
2008	\$81,383,328	\$8,080,034	9.9%	10%
2009	\$180,663,689	\$11,093,064	6.1%	15%
2010	\$425,682,727	\$22,059,554	5.2%	25%
2011	\$532,247,525	\$41,514,962	7.8%	40%
Weighted Loss Ratio				7.1%

## Rate Level Calculation (Continued)

Projected Hurricane Loss Ratio <sup>9</sup>	15.9%
Projected Incurred L/R (Non CAT)	7.1%
Expected Fixed Expense Ratio	26.0%
Expected Variable Expense Ratio	12.3%
CFA Rate Level Indication	-44.1%
Company Indicated Rate Level	-15.6%
Company Selected Rate Level	0.0%

## Conclusion

The request from Praetorian to leave rates unchanged is absurd. Only reducing the rates by 15.5 percent, which Praetorian said is indicated, is also not warranted. The rates should be reduced by at least 44.1 percent. The final indication, after full review of all components of the filing, will, I am sure, indicate a much larger decrease than 44.1 percent for reasons spelled out above. I urge Commissioners and the NAIC staff to carefully review the “trade secret” material on hurricane

<sup>8</sup> CFA did not review the LAE figures but we do note that the data on Page 8 of 25 of Exhibit 1 shows total non-hurricane LAE of \$ million (Column 16 plus Column 20 for the five years with incurred losses of \$52.1 million (Column 12) or a ratio of 19.8 percent, an extremely high provision that needs explaining.

<sup>9</sup> Not verified by CFA since these documents were not available for review (alleged “Trade Secrets”).

CATs and hurricane reinsurance. If Praetorian used the same type of actuarial overreach in these hidden documents as they did in the public documents, a rate decrease of much more, up to 85 to 90 percent, would be justified.

Finally, I should point out that the filing is misleading and cherry picks among assumptions to try to jack up the indication and then, after all the manipulation fails to create an indication of no change, the filer proposes that anyway. Making filings known to produce excessive prices for the borrower has gone on for decades in this business, as demonstrated all over the nation as observed loss ratios are far, far less than the expected loss ratios asked for in the filings. It is time for the NAIC to act to stop this sham.

**APPENDIX 2**

	FIRE INDUSTRY	FIRE BALBOA	FIRE AMER. SEC	
Loss Ratio (EP)	44.9%		18.3%	24.0%
LAE Ratio (EP)	5.5%		2.2%	2.8%
Commission Ratio (WP)	12.7%		9.0%	11.1%
Other Und Expense (WP)	14.0%		14.8%	29.0%
Profit	22.9%		55.7%	33.1%
Total	100.0%		100.0%	100.0%
	ALLIED INDUSTRY	ALLIED BALBOA	ALLIED AMER SEC	HOMEOWNERS INDUSTRY
Loss Ratio (EP)	76.7%	39.1%	43.1%	62.7%
LAE Ratio (EP)	7.9%	8.9%	3.5%	10.0%
Commission Ratio (WP)	12.4%	7.8%	9.3%	13.8%
Other Und Expense (WP)	13.7%	14.7%	33.8%	14.3%
Profit	-10.7%	29.5%	10.3%	-0.8%
Total	100.0%	100.0%	100.0%	100.0%

Sources: 2001-2010 Industry National Data from Best's Aggregates and Averages, 2011 Edition. American Security and Balboa: 2002 to 2011 national data from Statutory Page 14 of the Annual Statements of the insurer for loss ratios, Commissions and taxes. Other expenses from Best's Aggregates and Averages, taken from multiple editions.

Many years ago both insurers filed for expected loss ratios around the nation in the 55 percent to 60 percent range. As these data show, the filing projections were not realistic and, overall, the projections were more than double the reality.

