NAIC National Association of Insurance Commissioners
& The CENTER for INSURANCE POLICY and RESEARCH
CIPR newsletter

Consumer Viewpoints on Effective Disclosures

By Brenda J. Cude, Professor, University of Georgia, and NAIC Consumer Representative and Daniel Schwarcz, Associate Professor, University of Minnesota Law School and NAIC Consumer Representative

This article expresses the opinions of the authors and is not meant to represent the position or opinions of the NAIC or its members, nor is it the official position of any staff members.

◆ Introduction

Effective disclosure of complicated financial products is an increasingly important consumer protection issue. As the global financial crisis of 2008 demonstrated, many consumers fail to understand or appreciate important features of the financial products they purchase. In response to this deficiency in consumer understanding, there is increased attention across many fronts to more effectively communicate targeted information to consumers. One example is the federal Dodd-Frank Wall Street Reform and Consumer Protection Act, which created the Consumer Financial Protection Bureau (CFPB). Already, the CFPB has harnessed academic research and empirical methods to develop clear and robust consumer disclosures for non-insurance financial products, such as mortgages. The CFPB is merely one of several federal agencies revamping the ways in which consumer disclosures are designed.

Despite a renewed commitment to the disclosure of complex financial products at the federal level, the NAIC and state insurance regulators currently do not have a coordinated system to develop effective consumer disclosures for insurance products. While various NAIC model laws and regulations deal with the disclosure of insurance policy features—for example, laws and regulations governing disclosure of the terms of individual accident and sickness insurance policies,[1] consumer credit insurance,[2] long-term care insurance,[3] Medicare supplement insurance,[4] annuities[5] and health insurance policies[6]—the processes under which these laws were developed vary substantially.

The absence of coordinated processes to create consumer disclosure rules undermines the quality of those rules. First, it generates product-specific gaps in the intensity of disclosure rules that are often hard to justify. For instance, much more specific rules will govern the disclosure of health insurance products after implementation of the federal Patient Protection and Affordable Care Act than govern disclosure of property/casualty insurance products. Second, it results in unconsidered differences in approaches to disclosure regulation: depending on the underlying insurance product, disclosure rules can range from quantitative readability scores to rules prohibiting specifically designated terms to mandatory disclosure documents. Third, it undermines the NAIC's capacity to efficiently collect and make use of state-of-the-art knowledge and processes regarding effective consumer disclosures.

Insurance contracts are immensely complex legal documents. Without effective rules governing disclosure to consumers about the content of their policies, many consumers are at risk of failing to appreciate important elements of their insurance protection. Insurance contracts are drafted to communicate with courts and lawyers who are focused on particular questions, rather than to communicate with consumers about the broad range of potential scenarios that are relevant to making purchasing decisions. Typically, these contracts are not even provided to consumers until after the policy is purchased.

Consumer understanding of insurance policies is fundamental to the effective operation of insurance markets. The core products that insurers sell are insurance policies. Like all other markets, insurance markets are premised on the assumption that buyers can reasonably assess the value they place on different products. If consumers systematically fail to appreciate the important elements of insurance products, then they will tend to purchase coverage that does not meet their needs or preferences. Perhaps even more important, insurers may be rewarded for altering their policies in ways that ultimately harm consumer welfare and be penalized for increasing the generosity of their terms of coverage in ways that benefit consumers (Schwarcz, 2011).

Although certain principles cross-cut the design of effective consumer disclosures, this article does not focus on disclosures regarding issues other than the scope of insurance coverage, such as underwriting methods, consumer privacy or the existence of state guaranty funds. Additionally, this article's focus is on summary disclosures that are provided to consumers at the time of purchase or beforehand.

◆ The Purposes and Forms of Disclosures

The general purpose of information-disclosure requirements is to improve consumer information. Particularly relevant for insurance regulators is the prospect that insurance consumers may have incorrect or incomplete information re-

(Continued on page 27)

[1] NAIC Model Laws, Regulations and Guidelines 170-1, § 6.
[2] NAIC Model Laws, Regulations and Guidelines 360-1, § 6.
[3] NAIC Model Laws, Regulations and Guidelines 641-1, § 8.
[4] NAIC Model Laws, Regulations and Guidelines 650-1, § 5.
[5] NAIC Model Laws, Regulations and Guidelines 245-1, § 5.
[6] Proposed model disclosure.

garding the features of the insurance products they purchase or consider purchasing. There are several related reasons why regulation might attempt to correct this type of information deficiency (Kirsch, 2002).

First, regulators may pursue disclosure of insurance product features to improve consumers' product understanding. Product understanding enhances the likelihood that consumers will purchase the types of insurance products and features that best meet their needs and preferences. For instance, a consumer who is aware that her homeowners insurance policy does not cover floods may then decide whether to purchase federal flood insurance. Consumer understanding of insurance products is particularly important because of the role that moral hazard and adverse selection—both products of information asymmetries—play in the design of insurance products. Many insurance contract provisions are designed to limit the risk of moral hazard by excluding coverage for high-risk activities. But these contract provisions are only effective if policyholders are aware of them; otherwise, they merely shift moral hazard risk to consumers rather than causing consumers to take optimal levels of care.

Insurance contract provisions are also commonly designed to limit "adverse selection"; i.e., the prospect that high-risk policyholders will be drawn to insurance. By excluding coverage that is particularly valuable to high-risk individuals, insurance contracts can theoretically cause high-risk policyholders to "self-reveal" by purchasing more extensive coverage. Once again, this classic insurance contract solution to adverse selection does not work unless policyholders are familiar with the scope of the coverage they purchase.

A second core reason that regulators may require disclosure of product features is to enhance consumers' capacity to comparison shop, which allows consumers to find the coverage that best fits their needs and budgets. Informed comparison-shopping also improves the incentives of insurers to craft their products in a manner that genuinely reflects consumer preferences.

Third, regulators may require disclosure in order to promote fairness and transparency. The goal here is not to alter or inform consumer decision-making. Rather, it is fundamentally to provide consumers with a procedural right to inform themselves. This right may be valuable not because consumers frequently take advantage of it. Rather, its value lies primarily in promoting trust in the marketplace by assuring consumers that they have the capacity to become informed if they are so inclined.

Understanding the purpose or purposes of disclosure is crucial, as this purpose impacts the form that the disclosure ought to take. Broadly construed, there are two basic types of disclosure: summary disclosure and full disclosure. Summary disclosure is "often required at the point of purchase" and "highlight(s) the most relevant information in order to increase the likelihood that people will see it, understand it, and act in accordance with what they have learned" (Sunstein, 2010). Summary disclosure is generally aimed at either promoting product understanding or enhancing comparison-shopping. Because summary disclosure is intended to directly inform consumers by providing only the most relevant information, it presents numerous design challenges for regulators.

Full disclosure, by contrast, provides all relevant information, often including underlying data. Although full disclosure is not generally an effective strategy for promoting product understanding, it can be quite important to promote effective comparison-shopping. The reason is that full disclosure allows market intermediaries, such as consumer-oriented magazines, to offer advice to consumers about competing companies. It also may facilitate the capacity of a small minority of engaged consumers to make decisions that reflect full information, which can have positive effects on uninformed consumers (Schwartz and Wilde, 1979).

Finally, through the above two mechanisms, full disclosure helps to ensure that firms' reputations are more accurate. Full disclosure also can be an effective strategy to promote fairness and transparency, so long as consumers enjoy a realistic capacity to access this information.

Unlike summary disclosure, however, designing a system to provide full disclosure can be relatively straightforward, depending on the underlying context. Most important, there is no need for regulators to make decisions about which information to prioritize, as all information is disclosed. Additionally, while the usability of a full-disclosure system is important, greater sophistication can typically be expected of the audience for full disclosures. For these reasons, the balance of this article focuses on the design of summary disclosures.

◆ THE EFFECTIVENESS OF MANDATORY SUMMARY DISCLOSURE AS A REGULATORY TOOL

Mandatory summary disclosure is not an effective response to every market problem. In fact, mandated disclosure has often proven ineffective in responding to a variety of market

(Continued on page 28)

problems (Ben Shahar and Schneider, 2011). Moreover, the effectiveness of mandatory disclosure could well depend on the existence of complementary regulatory tools that are simultaneously deployed. For instance, mandating disclosure of pre-specified contract terms may be ineffective on its own, but quite effective if such disclosure were coupled with regulatory rules mandating the use of a limited number of specific policy forms.

Two basic conditions should be met in order for summary mandatory disclosure to constitute an effective regulatory strategy. First, consumers must systematically make suboptimal choices *because they lack relevant information* (Weil, Fung, Graham and Fogotta, 2006). There are a variety of reasons other than deficits in information that consumers may make decisions that raise regulatory concerns. In some cases, for instance, consumers may make problematic decisions because the benefits or costs of their decisions are felt largely by others (externalities). Thus, some consumers may fail to purchase automobile insurance because the cost of that failure is primarily borne by potential accident victims.

Alternatively, research increasingly demonstrates that consumers often systematically make certain types of mistakes because of cognitive heuristics and biases. These mistakes can relate to product attributes, such as the coverage that an insurance product provides, as well as use patterns, such as how often the consumer will make a claim (Bar-Gill and Ferarri, 2010). In certain instances, these heuristics and biases can be manipulated by market actors to exacerbate the likelihood of consumer mistakes or magnify the consequences of those mistakes. To take one common example, there is good evidence that consumers suffer from behavioral biases that lead them to purchase policies with deductibles that are too low (Kunreuther and Pauly, 2005). When consumer behavior is the result of either externalities or cognitive biases, information disclosure on its own will rarely be an effective remedy.

Second, it must be the case that, with the information that is provided in a disclosure, consumers would have the will and capacity to change their behavior. In some cases, the underlying product or market context may make effective disclosure that actually impacts consumer behavior practically impossible, irrespective of the amount of care and effort that is put into crafting such disclosures. This may be most likely when the relevant information is sufficiently complex that it cannot be boiled down to a basic metric, piece of information or recommendation. It also may be particularly likely when the required timing of any disclosure means that it will be provided to the consumer at the same time as numerous other disclosures or after the consumer has made the psychological commitment to the purchase. Alternatively, disclosures may be less effective if they are provided and/or explained by individuals who have financial incentives to undermine the essential message of that disclosure.

Effective disclosure may also prove impossible when consumers lack basic knowledge of the insurance product about which information is being disclosed. In such cases, consumers may be unable to meaningfully use the disclosed information. For example, disclosing that wellness visits are not subject to a deductible may mean little to a consumer who does not know what either a wellness visit or a deductible is. Although this problem may be overcome where consumers can be provided basic consumer education as a component of or a companion to disclosure, in many cases, such consumer education may not be practical, thus rendering disclosure an inappropriate regulatory tool.

If relevant information will improve consumer decisions, and consumers have the will and capacity to change their behavior, then information disclosure may be an appropriate response. However, such disclosures must be carefully designed to inform decisions, rather than constituting mere technical requirements. As Cass Sunstein, the former head of the federal Office of Information and Regulatory Affairs, explained in a June 18, 2010, memo for the heads of executive departments and agencies: "There is a difference between making a merely technical disclosure—that is, making information available somewhere and in some form, regardless of its usefulness—and actually informing choices. Well-designed disclosure policies are preceded by a careful analysis of their likely effects." Susan Kleimann, a consumer communications expert, said in an interview, "Disclosure is most appropriate when data can be changed into information and then into knowledge and then consumers can do something with that—make an informed decision."

In sum, the following threshold questions should be answered to determine if disclosure is an appropriate consumer-protection response to address a market issue. In assessing these questions, regulators should remember that mandatory disclosure can, and often should, be used in conjunction with other regulatory tools, such as product standardization, regulatory review, consumer education and minimum product requirements.

- What is the underlying market problem generating the need for a regulatory response? Is this market problem driven by consumers' lack of information, or instead by

(Continued on page 29)

externalities or cognitive biases? If it is driven by multiple causes, to what extent can disclosure be coupled with other regulatory techniques more appropriate to alternative causes of the problem?

- Can consumers reasonably be expected to make better decisions with the information? What structural impediments are likely to affect consumers' capacity to digest information, and to what extent are those impediments capable of being counteracted through a regulatory mechanism?
- When do insurance consumers need the information to be disclosed? Can the information be delivered to consumers at that time? To what extent will disclosure be provided by an individual or entity whose financial interests are potentially undermined by the disclosure?
- In what form should the information be delivered? Can the information be delivered to consumers in that way?
- Do consumers have sufficient experience with the product to use the information? If not, would an educational product (in addition to the information disclosure) improve consumers' use of the information to achieve the stated purpose of the disclosure?
- Can additional regulatory strategies be effectively combined with mandatory disclosure? Would any of these supplemental approaches address some of the drawbacks or limitations of mandatory disclosure?

◆ Specific Recommendations for Designing Disclosures in Insurance

Insurance regulators who are considering consumer disclosure as a regulatory response can think of the process as having eight steps. Consumer advocates recommend that regulators follow these steps when developing consumer disclosures:

1. Confirm that disclosure is the appropriate regulatory response.
2. Identify the purpose and expected outcome(s) of the disclosure.
3. Identify the content of the disclosure.
4. Determine whether the disclosure is to be drafted by the regulator or will be drafted by insurers pursuant to specified guidelines and criteria.
5. Ensure the readability of the disclosure.
6. Design the disclosure or, for disclosures to be provided by insurers, provide guidelines and criteria by which to evaluate the design.
7. Determine when and how the disclosure should be delivered for maximum effectiveness.
8. Determine whether testing of the disclosure with consumers is useful.[7]

Further explanations of the recommended steps in developing consumer disclosures follow:

1. Confirm that disclosure is the appropriate regulatory response.

Considerations to determine whether a disclosure is an appropriate response:

- What is the regulatory issue?
- Will the disclosure help the consumer make better decisions?
- Do consumers have sufficient experience with the product to use the information? If not, would educational material—such as a brochure or pamphlet (in addition to, or in lieu of, the information disclosure)—improve consumers' use of the information to achieve the stated purpose of the disclosure?

2. Identify the purpose and expected outcome(s) of the disclosure.

After determining that disclosure is indeed an appropriate regulatory approach, the next step in developing the disclosure should be to identify the purpose of the disclosure. Regulators should carefully consider and specifically articulate what consumer decisions the disclosure is intended to impact. A best practice would be for regulators to be as specific as possible in describing the goals of a disclosure.

3. Identify the content of the disclosure.

The most crucial issue in designing any summary disclosure is determining what information should be provided in that disclosure. As a rule, it is more difficult to provide effective consumer disclosure for complex products or when the information to be disclosed is more complex. Decisions about content are specific to individual disclosures; however, the following key principles should shape this determination.

First, the purpose of the disclosure, as identified in recommendation #2, should be a guiding force in deciding on the content of the disclosure. All content should be scrutinized to assess the extent to which it advances this goal.

Second, regulators must always bear in mind that there is a natural limit to the amount of information that can be effectively provided to consumers. If disclosures include more

(Continued on page 30)

[7] See Perry and Blumenthal (2012) and Kozup, Taylor, Capella and Kees (2012) for a discussion of testing the effectiveness of disclosures.

than a few pieces of information, those disclosures typically will be ineffective. It is important to remember that disclosures are only effective when consumers understand what they mean.

4. Determine whether the disclosure is to be drafted by the regulator or will be drafted by insurers pursuant to specified guidelines and criteria.

When establishing the information to be disclosed, regulators must also determine how it is to be stated, providing the precise language. Or, they may specify the content to be communicated, leaving the precise language up to the insurers. Writing the disclosure obviously puts an additional burden on the regulator. However, in the long run it has two advantages:

- It creates consistency across companies, which facilitates comparison shopping among consumers by allowing them to easily assess the differences among competing products.
- It eliminates any unnecessary enforcement responsibility on regulators who would otherwise have to determine whether the disclosure actually communicated the required information.

5. Ensure the readability of the disclosure.

True readability requires disclosures using plain language that is designed to facilitate consumer understanding. Guidelines for writing plain-language documents are available at the www.Plain Language.gov. A typical checklist includes most of the items identified below:

- Avoid jargon, technical language, or extraneous information.
- Require an action (signature/initials/checklist).
- Do not repeat information.
- Provide examples.
- Use short sentences.
- Provide a way to get more information online, by phone and/or in person.
- Include a glossary.
- Make the information as specific as possible to the individual consumer; if that is not feasible, make it specific to the product and/or the decision being made.
- Write for the average reader, which requires knowing the intended audience for the disclosure.
- Use "you" and other pronouns that the reader can identify with.
- Use active voice.
- Omit excess words. Use concrete, familiar words.
- Use "must" to express requirements; avoid the ambiguous "shall."

The words in a document are not the only factor that determines how readable that document is. The organization of a document has an equal or greater influence. In organizing a disclosure, regulators should:

- Use a title that communicates the value to the consumer of reading the disclosure and headings that help consumers find the information they need.
- Put the most important information near the beginning (i.e., the purpose, action required).
- Break information into sections.
- Consider using a question and answer format.
- Make the disclosure as short and concise as possible.

6. Design the disclosure or, for disclosures to be provided by insurers, provide guidelines and criteria by which to evaluate the design.

The design of a disclosure influences its usefulness to consumers. Even consumers who are capable of understanding a complex document will often not devote the time and energy to do so, unless it is in a format that is easy to read. Some design suggestions include:

- Use a format that looks readable (bullet-point items, charts, lists). Lines longer than 65 characters are difficult to read.
- Do not justify the right-hand margin or use all capital letters.
- Use vertical (rather than horizontal) lists.
- Use color and highlighting to emphasize important points and to signal section changes.
- Use a larger font.
- Make the disclosure look important (put it on different color or type of paper; present it separately from other paperwork).
- Highlight any action suggested or required.
- Do not use small sheets of paper (which require small font).
- Make the disclosure as short and concise as possible.

7. Determine when and how the disclosure should be delivered for maximum effectiveness.

(Continued on page 31)

The timing of a disclosure is crucially important in determining its ultimate effectiveness. Consequently, regulators must carefully consider when consumers need the information in the disclosure in light of the disclosure's purpose. Particularly important on this front is to provide consumers with disclosures intended to promote comparison-shopping at a time before the consumer has emotionally committed to a purchase or spent a substantial amount of time and energy learning about or applying for a specific product. Thus, making a disclosure available early is important. Regulators may also wish to address the need for delivery requirements, such as maintaining a record of delivery of that disclosure.

8. Determine whether testing of the disclosure with consumers is useful.

Consumer testing of proposed disclosures can assist regulators in evaluating the effectiveness of the disclosures. Consumer testing could be considered a "best practice" in crafting disclosures, but the necessity of utilizing consumer testing must be balanced against the costs, potential delay and efficacy of conducting such evaluation. Consequently, regulators should consider whether resources are available when determining whether testing should be conducted.

Consumer testing can range from informal distribution of a proposed disclosure for comment and suggestion up to engaging professionals to test prototype disclosures. This range includes, but is not limited to:

- Presentation of the proposed disclosure to a consumer group, such as a consumer insurance council, for review, comment and suggestions as to effectiveness and clarity.
- Use of structured focus groups of a small number of individuals using open-ended questions to collect information across a spectrum of potential users of the disclosure.
- Cognitive interviewing of a small number of consumers to explore how consumers make sense of the information within a document. Cognitive interviewing is a one-to-one technique that allows the interviewer to explore individual responses to capture the consumer's thinking process and understanding.
- Online testing may be conducted by asking consumers to choose between various formats, such as mapping how consumers "click through" parts of a disclosure (i.e., a "heat map" that displays graphically which areas were clicked on most).

More complex disclosures may benefit from consumer testing to ensure they are understandable and effective, but consumer testing may not be necessary for more simple disclosures. Regulators must balance the need for consumer testing against the costs and complexity of conducting such testing. If it is determined to be appropriate to do consumer testing, regulators should choose a testing procedure which will produce the highest effectiveness for the resources expended.

◆ SUMMARY

The development and implementation of effective disclosures is an important issue for insurance regulators and the consumers they serve. The authors hope this article provides useful guidance regarding consumer disclosures. Regulators should keep in mind the complexity of insurance information and, therefore, when developing disclosures, seek to communicate in ways that will increase consumer understanding.

References used in this article:

- Bar-Gill, O. and Ferrari, F. (2010). Informing Consumers about Themselves, *Erasmus Law Review*, 3(2), 93-119.
- Bason, J.J., and Mauney, M.A. (2005, March). National Association of Insurance Commissioners Insurance Disclosure Focus Group Study. Kansas City: National Association of Insurance Commissioners.
- Ben Shahar O., and Schneider, C. (2011). The Failure of Mandated Disclosure. *University of Pennsylvania Law Review*, 159, 647-749.
- Cogan, Jr., J.A. (2009, August 20). Plain English is the best policy. *The New York Times*.
- Cude, B.J. (2005). Insurance disclosures: An effective mechanism to increase consumers' insurance market power? Journal *of Insurance Regulation*, 24(2), 57-80.
- Frey, D. (1982). Different levels of cognitive dissonance, information seeking, and information avoidance. *Journal of Personality and Social Psychology*, 43(6), 1175-1183.
- Greenwald, M. (2005). Using research to help make disclosure statements more effective: A case study in research design and implementation. *Journal of Insurance Regulation*, 24(2), 11-20.
- Jin, G. and Leslie, P. (2003). The Effect Of Information On Product Quality: Evidence From Restaurant Hygiene Grade Cards. Quarterly *Journal of Economics*, 118(2), 409-450.
- Kirsch, L. (2002). Do product disclosures inform and safeguard insurance policyholders? *Journal of Insurance Regulation*, 20(2), 271-295.
- Kleimann Communication Group, Inc. (2006). Evolution of a Prototype Financial Privacy Notice: A Report on the Form Development Project, *www.ftc.gov/privacy/privacyinitiatives/ftcfinalreport060228.pdf*.
- Kozup, J., Taylor, C.R., Capella, M.L., and Kees, J. (2012). Sound disclosures: Assessing when a disclosure is worthwhile. *Journal of Public Policy and Marketing*, 31(2), 313-322.
- Kunreuther, H. and Pauly M. (2005). Insurance Decision-Making and Market Behavior. *Foundations and Trends in Microeconomics*, 1(2), 63-127.

(Continued on page 32)

- Lanam, L. (2005). Consumer disclosure as consumer protection. *Journal of Insurance Regulation, 24*(2), 7-10.
- Malbon, J. (2010, October), America's Health Insurance Plans Focus Group Summary. Seattle, WA: JKM Research.
- Malbon, J. (2011, May), America's Health Insurance Plans Blue Cross Blue Shield Association Focus Group Summary. Seattle, WA: JKM Research.
- National Center for Education Statistics. (2009). *Basic Reading Skills and the Literacy of America's Least Literate Adults: Results from the 2003 National Assessment of Adult Literacy (NAAL) Supplemental Studies).* NCES 2009-481. Washington, D.C.: U.S. Department of Education.
- People Talk Research and Consumers Union. (2010). Early Consumer Testing of New Health Insurance Disclosure Forms. Washington, D.C.: Author.
- Perry, V. G., & Blumenthal, P. M. (2012). Understanding the fine print: The need for effective testing of mandatory mortgage loan disclosures. *Journal of Public Policy and Marketing, 31*(2), 305-312.
- Schwarcz, D. (2007). A Products Liability Theory for the Judicial Regulation of Insurance Policies. *William & Mary Law Review*, 48, 1389-1463.
- Schwarcz, D. (2011). Reevaluating Standardized Insurance Policies. *University of Chicago Law Review*, 78, 1263-1348.
- Schwartz, A & Wilde L. (1979). Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis. University of Pennsylvania Law Review, 127, 630-682.
- State of Rhode Island. (2009). Office of the Health Insurance Commissioner Regulation 5: Standards for Readability of Health Insurance Forms.
- Sunstein, C. (2010). Disclosure and Simplification as Regulatory Tools. Memorandum for the Heads of Executive Departments and Agencies, available at http://www.whitehouse.gov/sites/default/files/omb/assets/inforeg/disclosure_principles.pdf
- Toppo, G. (2009). Literacy study: 1 in 7 U.S. adults are unable to read this story. *USA Today.*
- Weil, D., Fung, A., Graham, M., & Fagotta, E. (2006). The effectiveness of regulatory disclosure policies. *Journal of Policy Analysis and Management, 25*(1), 155-181.
- Wroblewski, M. (2005). Uniform health insurance information can help consumer make informed purchase decisions. *Journal of Insurance Regulation, 24*(2), 21-37.

NAIC Central Office
Center for Insurance Policy and Research
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197
Phone: 816-842-3600
Fax: 816-783-8175

http://www.naic.org http://cipr.naic.org