

ANALYSIS OF THE NEW JERSEY  
FISCAL YEAR 2003 - 2004 BUDGET



DEPARTMENT OF BANKING AND INSURANCE

PREPARED BY

OFFICE OF LEGISLATIVE SERVICES

NEW JERSEY LEGISLATURE

APRIL, 2003

## NEW JERSEY STATE LEGISLATURE

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# DEPARTMENT OF BANKING AND INSURANCE

Budget Pages..... C-9; C-16; C-33; D-25 to D-32; F-8;  
H-31

## Fiscal Summary (\$000)

	Expended FY 2002	Adjusted Appropriation FY 2003	Recommended FY 2004	Percent Change 2003-04
State Budgeted	\$66,241	\$68,959	\$68,018	(1.4)%
Federal Funds	0	0	0	—
<u>Other</u>	<u>16,553</u>	<u>10,570</u>	<u>10,238</u>	<u>(3.1)%</u>
Grand Total	\$82,794	\$79,529	\$78,256	(1.6)%

## Personnel Summary - Positions By Funding Source

	Actual FY 2002	Revised FY 2003	Funded FY 2004	Percent Change 2003-04
State	510	466	488	4.7%
Federal	0	0	0	—
<u>Other</u>	<u>5</u>	<u>3</u>	<u>5</u>	<u>66.7%</u>
Total Positions	515	469	493	5.1%

FY 2002 (as of December) and revised FY 2003 (as of September) personnel data reflect actual payroll counts. FY 2004 data reflect the number of positions funded.

## Introduction

The Department of Banking and Insurance is primarily responsible for the State's regulation and monitoring of the banking and insurance industries. The Division of Banking is authorized with the chartering, licensing and supervision of banks, savings and loans, and a wide range of other financial institutions and firms responsible for consumer finance in the State. The Division of Insurance monitors and examines the policies, practices and financial condition of insurance companies, including the financial condition of health maintenance organizations, and licenses and regulates insurance producers. The division also monitors the business activities of real estate brokers and agents. The two divisions were formerly distinct departments and were consolidated into the current Department of Banking and Insurance in FY 1997. The department is fully funded by the industries it regulates.

## Key Points

- The department's recommended General Fund appropriation is \$68 million, representing a decrease of 1.4 percent or \$941,000 below the FY 2003 adjusted appropriation. This decrease represents reductions in non-salary operating costs and Office of Information and Technology reimbursements, consolidation of Anti-Fraud Compliance, reorganization of the Office of the Insurance Ombudsman and attrition savings.
- While appropriations for Insurance Fraud Prevention and Insurance Fraud Prosecution remain within the department, the fraud prevention investigator functions were shifted to the Department of Law and Public Safety in FY 1999. These appropriations remain within the department's budget display because they are still funded through insurance industry assessments. However, all but \$2.1 million of the \$32 million appropriated for this purpose will be expended by the Department of Law and Public Safety. The \$2.1 million will be utilized to fund the Anti-Fraud Compliance Unit within the Department of Banking and Insurance.
- The proposed FY 2004 budget anticipates revenues for the department of \$98.5 million, an increase of \$2.5 million or 2.6 percent over the current year's estimate of \$96 million. These revenue figures are predicated on the assumed passage of legislation that provides that the New Jersey Real Estate Commission increase licensing fees for salespersons and brokers resulting in \$4.5 million in additional revenue.
- Proposed budget language (page F-8) recommends a transfer of \$15 million from the Stock Workers' Compensation Security Fund to the General Fund as State revenue. The fund (page H-31) is funded exclusively by assessments levied against stock insurance carriers writing workers' compensation insurance (stock insurance carriers are owned and controlled by stockholders, in contrast to mutual carriers which are controlled by each insured as a member of the corporation). Payments from the fund are made to persons entitled to receive workers' compensation when a stock carrier is determined to be insolvent.

### Background Paper:

- The "New Jersey Home Ownership Security Act of 2002" - Protections For Consumers From Abusive or Predatory Lending Practices p.13

## Program Description and Overview

The primary responsibilities of the Department of Banking and Insurance are the regulation and monitoring of the banking and insurance industries. The Division of Banking charters, licenses and supervises banks, savings and loans, and a wide range of other financial institutions and firms responsible for consumer finance in the State. The Division of Insurance monitors and examines policies, practices and the financial condition of insurance companies. The Division of Insurance also monitors the business activities of real estate brokers and agents. Previously, two separate departments, the former Department of Banking and Department of Insurance, were merged by P.L. 1996, c.45 (C.17:1-13 et seq.) to form the current Department of Banking and Insurance. The department is fully funded by the industries it regulates.

### Division of Banking

The **Division of Banking** is responsible for chartering, licensing and supervising commercial and savings banks, savings and loan associations, limited trust companies and credit unions. The division is also responsible for licensing, examining and supervising a number of other financial service entities, including, but not limited to: licensed lenders (mortgage bankers and brokers, mortgage solicitors, consumer lenders, secondary mortgage lenders and sales finance companies); money transmitters and foreign money transmitters; insurance premium finance companies, pawnbrokers and check cashers.

The division consists of two offices, the **Office of Depositories** and the **Office of Consumer Finance**. The Office of Depositories conducts examinations of State-chartered banking and savings and loan institutions, and takes enforcement action if it discovers any violations of banking statutes or regulations. It also processes and reviews applications by depository institutions for new charters, branches, relocations, plans of acquisition, mergers, bulk sales, stock conversions and auxiliary offices. The Office of Consumer Finance examines, and when appropriate, takes enforcement actions against, the other entities regulated by the division and also investigates complaints filed by consumers.

In its oversight functions, the division works closely with the Federal Deposit Insurance Corporation (the FDIC insures the deposits of all chartered institutions); the Board of Governors of the Federal Reserve System, which oversees State-chartered banks that are members of the Federal Reserve System; and the federal Office of Thrift Supervision (OTS), which oversees savings and loan associations. The division and the Federal Reserve examine State-chartered commercial banks on an alternating basis. The division shares information with the OTS to decide whether State examinations of certain State-chartered savings and loan associations are necessary.

While the primary functions of the Division of Banking have not changed significantly in recent years, its responsibilities and workload have changed as a consequence of an increase in the number of new bank charters, the need to examine financial institutions, additional categories of licensure, and changes in State and federal laws and regulations.

The passage of various federal laws in the 1990's significantly increased the division's workload, as well as its staff training requirements. The passage of the Gramm-Leach-Bliley Act of 1999 (GLBA) repealed the last vestiges of the Glass Steagall Act of 1933, including the restrictions placed on cross-industry affiliations, and authorized the creation of a new entity, the financial holding company, permitted to engage in underwriting and selling insurance and securities. GLBA also confirms state regulation of insurance, while prohibiting states from discriminating against persons affiliated with a bank; permits national banks to engage in new financial activities through financial subsidiaries; initiates processes for creating uniform nationwide licensing of insurance

## Program Description and Overview (Cont'd)

agents and brokers; permits national bank subsidiaries and affiliates to sell all types of insurance, including title insurance; preempts state laws that interfere with affiliations between banks and insurance companies; and requires every financial institution to disclose its policy regarding the sharing of "non-public personal information" with affiliates and with third parties and requires that consumers be given an opportunity to "opt out" of sharing their non-public personal information with nonaffiliated third parties.

Also included within the division is the **Pinelands Development Credit Bank**, which is empowered to purchase and sell development rights in the Pinelands region. The intent of the program is to simplify both the preservation of resources of the Pinelands area and the accommodation of regional growth influences in an orderly fashion.

### Division of Insurance

The **Division of Insurance** monitors and examines the policies, practices and financial condition of insurance companies, including the financial condition of health maintenance organizations, and licenses and regulates insurance producers (brokers and agents). According to the department, the division has direct regulatory responsibility over approximately 110 domestic insurance companies, 106,000 licensed producers and 1,200 public adjusters. In addition, the division works in conjunction with the Department of Law and Public Safety to enforce insurance fraud laws, administers the Unsatisfied Claim and Judgment Fund, regulates the training and licensing of real estate agents and brokers and investigates consumer inquiries or complaints regarding these industries.

Over the past several years, the division has expanded and revised its responsibilities as a result of statutory changes and as a result of major events and changes within the insurance industry. For example, during fiscal year 2003 the Division of Insurance engaged in an effort to provide incentives for uninsured motorists to purchase automobile insurance through the "Last Chance" to "Get Legal" program. The "Last Chance" program provided uninsured motorists, for a limited time, the opportunity to purchase insurance and "Get Legal" without paying the underwriting surcharges which are usually imposed. The "Last Chance" program provided motorists with a savings of between \$115 to \$1,300 a year by purchasing coverage through the Personal Automobile Insurance Plan (NJ-PAIP).

The "Automobile Insurance Cost Reduction Act," P.L. 1998, c.21 (AICRA) provided for an overall 15 percent reduction in automobile insurance rates. Several modifications were made to the existing system, including: the creation of a basic automobile insurance policy (implementation of the basic policy encourages motorists who otherwise would be uninsured to obtain required insurance coverage), in addition to the standard automobile insurance policy; and the adoption of medical protocols that reduce overuse and fraud in the treatment of injuries from automobile accidents, while ensuring that doctors provide necessary treatment to those who are truly injured. The law also established the **Office of Insurance Claims Ombudsman**, charged with the responsibility to: investigate consumer complaints regarding insurance policies and the payment of claims; monitor the implementation of various insurance regulations; respond to consumer inquiries about policy provisions and coverage availability; and publish and distribute buyers' guides and comparative rates. Pursuant to AICRA, the fraud investigative functions of the former Division of Insurance Fraud Prevention were transferred to the newly created **Office of the Insurance Fraud Prosecutor**, housed within the Department of Law and Public Safety. At the same time, the **Anti-Fraud Compliance Unit** was established within the Department of Banking and Insurance. The Anti-Fraud Compliance Unit is charged with three primary functions: insurance industry compliance, collection of penalties and fines, and industry education. AICRA also

## Program Description and Overview (Cont'd)

established the **Automobile Insurance Territorial Rating Plan Advisory Commission** which is responsible for the revision of the current territorial rating plan, another aspect of automobile insurance reform. State law places a cap on the automobile insurance premiums that can be charged in certain areas of the State which are inadequate to cover the losses that are generated there and shifts those costs to other New Jersey drivers to subsidize the rates. The law therefore mandates the commission to review and revise these geographic territories for the first time in over 50 years.

As a result of the increase in competition within the automobile insurance industry, the department has developed the "**Consumer Handbook on Tier Rating**," to educate consumers to "shop" comparatively for automobile insurance. This handbook provides concise, comparative information about New Jersey's automobile insurers, including a wide range of prices available for automobile insurance policies. According to the department, consumer "shopping" increased by 20 percent since the implementation of tier rating.

### The Recommended FY 2004 Budget

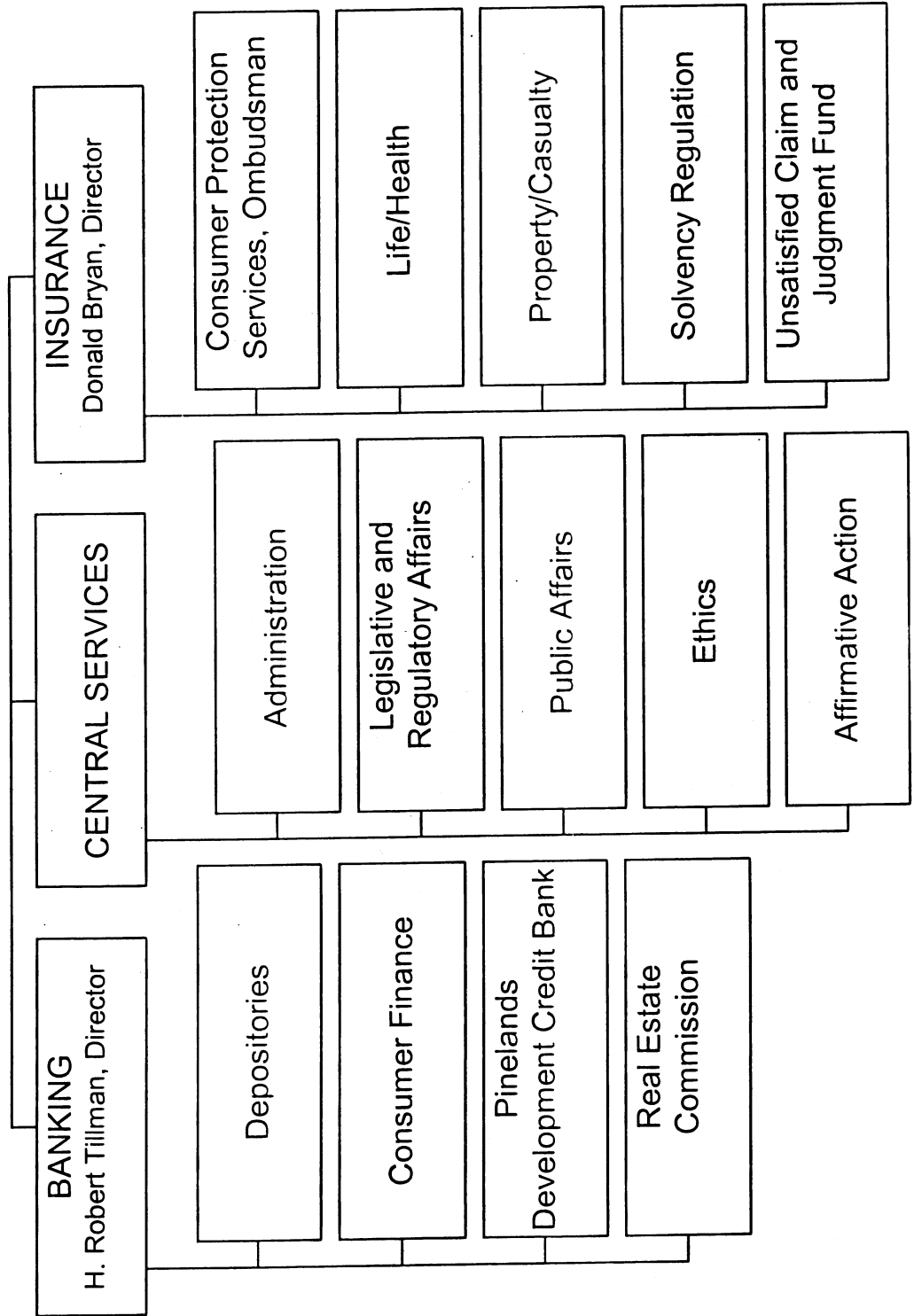
The department's recommended FY 2004 budget of \$68.0 million in Direct State Services funding, and \$10.2 million from All Other Funds, is a decrease of \$1.3 million or 1.6 percent from the current fiscal year. The funding decrease of 1.6 percent is a result of: reductions in non-salary operating costs and Office of Information and Technology reimbursements; consolidation of Anti-Fraud Compliance; reorganization of the Office of the Insurance Ombudsman; and overall attrition savings. The bulk of \$10.2 million in All Other Funds in the department's budget represents insurance industry assessments imposed to cover shared program losses related to the New Jersey Individual Health Coverage Program, P.L.1992, c.161. Budget language authorizes this program to operate from receipts.

Although appropriations for Insurance Fraud Prevention and Insurance Fraud Prosecution remain within the department's display in the Governor's proposed budget, these functions were transferred to the Office of the Insurance Fraud Prosecutor in the Department of Law and Public Safety. The appropriations remain within the department's display since the industry funds them through insurance assessments. The Department of Law and Public Safety will expend all but \$2.1 million of the \$32 million recommended in FY 2004 for this purpose. The Division of Insurance will utilize the remaining \$2.1 million to fund the Anti-Fraud Compliance Unit within the Department of Banking and Insurance.

The proposed FY 2004 budget anticipates revenues for the department of \$98.5 million, an increase of \$2.5 million or 2.6 percent over the current year's estimate of \$96 million. These revenue figures are predicated on the anticipated passage of legislation that authorizes increases in licensing fees for salespersons and brokers charged by the New Jersey Real Estate Commission, resulting in \$4.5 million in additional revenue. Anticipated FY 2004 revenues include an estimated \$16.9 million from the "Special Purpose Assessment." Pursuant to P.L. 1995, c.156 (C.17:1C-19 et seq.), the Special Purpose Assessment consolidates certain insurance industry fees and charges to streamline the department's billing and collection process and to permit the department to charge insurers for all direct and indirect costs to the department.

# Organization Chart

**DEPARTMENT OF BANKING AND INSURANCE**  
**HOLLY C. BAKKE**  
**COMMISSIONER**





## Fiscal and Personnel Summary

### AGENCY FUNDING BY SOURCE OF FUNDS (\$000)

	Expended FY 2002	Adj. Approp. FY 2003	Recom. FY 2004	Percent Change	
				2002-04	2003-04
<b><u>General Fund</u></b>					
Direct State Services	\$66,241	\$68,959	\$68,018	2.7%	(1.4)%
Grants-In-Aid	0	0	0	0.0%	0.0%
State Aid	0	0	0	0.0%	0.0%
Capital Construction	0	0	0	0.0%	0.0%
Debt Service	0	0	0	0.0%	0.0%
<b>Sub-Total</b>	<b>\$66,241</b>	<b>\$68,959</b>	<b>\$68,018</b>	<b>2.7%</b>	<b>(1.4)%</b>
<b><u>Property Tax Relief Fund</u></b>					
Direct State Services	\$0	\$0	\$0	0.0%	0.0%
Grants-In-Aid	0	0	0	0.0%	0.0%
State Aid	0	0	0	0.0%	0.0%
<b>Sub-Total</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>0.0%</b>	<b>0.0%</b>
<b>Casino Revenue Fund</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>0.0%</b>	<b>0.0%</b>
<b>Casino Control Fund</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>0.0%</b>	<b>0.0%</b>
<b>State Total</b>	<b>\$66,241</b>	<b>\$68,959</b>	<b>\$68,018</b>	<b>2.7%</b>	<b>(1.4)%</b>
<b>Federal Funds</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>0.0%</b>	<b>0.0%</b>
<b>Other Funds</b>	<b>\$16,553</b>	<b>\$10,570</b>	<b>\$10,238</b>	<b>(38.2)%</b>	<b>(3.1)%</b>
<b>Grand Total</b>	<b>\$82,794</b>	<b>\$79,529</b>	<b>\$78,256</b>	<b>(5.5)%</b>	<b>(1.6)%</b>

### PERSONNEL SUMMARY - POSITIONS BY FUNDING SOURCE

	Actual FY 2002	Revised FY 2003	Funded FY 2004	Percent Change	
				2002-04	2003-04
State	510	466	488	(4.3)%	4.7%
Federal	0	0	0	0.0%	0.0%
All Other	5	3	5	0.0%	66.7%
<b>Total Positions</b>	<b>515</b>	<b>469</b>	<b>493</b>	<b>(4.3)%</b>	<b>5.1%</b>

FY 2002 (as of December) and revised FY 2003 (as of September) personnel data reflect actual payroll counts. FY 2004 data reflect the number of positions funded.

### AFFIRMATIVE ACTION DATA

Total Minority Percent	26.0%	28.6%	28.2%	----	----
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**Significant Changes/New Programs (\$000)**

<u>Budget Item</u>	<u>Adj. Approp. FY 2003</u>	<u>Recomm. FY 2004</u>	<u>Dollar Change</u>	<u>Percent Change</u>	<u>Budget Page</u>
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**ECONOMIC REGULATION****DIRECT STATE SERVICES**

Saleries and Wages	\$28,806	\$28,333	(\$473)	(1.6)%	D-30
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This reduction in salary funding consists of deferred early retirement savings (\$229,000), annualized attrition savings (\$68,000) and efficiencies in the Office of Anti-Fraud Compliance.

**Services Other Than**

**Personal: Licensing and  
Regulatory Affairs**

\$4,192	\$3,825	(\$367)	(8.8)%	D-30
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According to the Office of Management and Budget, \$250,000 of the \$367,000 decrease is attributable to a reduction in non-salary operating costs within the Division of Insurance and the remaining \$117,000 is due to a reduction in reimbursements to the Office of Information and Technology.

**Special Purpose:**

<b>Ombudsman Program</b>	<b>\$801</b>	<b>\$700</b>	<b>(\$101)</b>	<b>(12.6)%</b>	<b>D-30</b>
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According to the Office of Management and Budget, this decrease is the result of the elimination of a Deputy Director salary, as part of the reorganization of the Office of the Insurance Ombudsman.

## Language Provisions

### 2003 Appropriations Handbook

### 2004 Budget Recommendations

p. B-14

Notwithstanding any provisions of law to the contrary, any surplus remaining in the New Jersey Medical Malpractice Reinsurance Recovery Fund after all financial obligations of the New Jersey Medical Malpractice Reinsurance Association are funded, as determined by the Director of the Division of Budget and Accounting, are appropriated for transfer to the General Fund as State revenue.

No comparable language.

#### Explanation

This language is discontinued because no balance remains in the Medical Malpractice Reinsurance Recovery Fund (MMRRF). In FY 2002, \$14 million remained in the MMRRF of which \$11 million was transferred to the General Fund. The remaining approximately \$3 million was appropriated, per the above language, to the New Jersey Medical Malpractice Reinsurance Association to pay for outstanding insurance claims.



## Discussion Points

1. During the past year, the availability and affordability of medical malpractice liability insurance has become a significant public issue in this State. Physicians in certain high-risk specialties, such as radiology, neurosurgery, orthopedics and obstetrics and gynecology, have experienced rapidly escalating rates and increased premiums. This situation has caused physicians to demonstrate at the State Capitol in support of certain tort reforms.

In response, and after much deliberation on the issues surrounding medical malpractice liability insurance costs, the Legislature is considering an omnibus reform bill, the "New Jersey Medical Care Access and Responsibility and Patients First Act." That legislation provides for a comprehensive set of reforms affecting the State's tort liability system, health care system and medical malpractice liability insurance carriers to ensure that health care services continue to be available and accessible to residents of the State and that patient safety at health care facilities is enhanced. The bill was passed by the Senate on March 20, 2003 and is currently awaiting review by the Assembly, which had previously passed a different version of the bill.

Earlier, in August, 2002, P.L. 2002, c.55 was enacted which authorized the Commissioner of Banking and Insurance to collect data from medical malpractice liability insurers that the Department might not have otherwise been able to gather, given its limited regulatory role of commercial insurers pursuant to the "Commercial Insurance Deregulation Act of 1982," P.L.1982, c.114 (C.17:29AA-1 et seq.). Pursuant to P.L. 2002, c.55, the Commissioner has issued three separate orders requiring medical malpractice liability insurers that do business in New Jersey to submit premium, loss and related data on certain premium increases for physicians, podiatrists and nurses.

- **Questions:** a. Please explain the department's efforts to date in addressing the issues of availability and affordability of medical malpractice insurance.
- b. Please detail the names and number of medical malpractice liability insurers currently doing business in New Jersey. How many such insurers have ceased doing business in this State in the past year? How many people had they insured? Have any other insurers, reciprocals or self-funded plans applied to provide medical malpractice liability insurance in New Jersey? What is their potential for insuring physicians in this State?
- c. In light of the enactment of P.L. 2002, c.55 and the Orders issued by the Commissioner pursuant to that law, please detail the type of data that was requested from medical malpractice insurers. What additional information, if any, was requested from those insurers? What findings, if any, has the department made with respect to the information submitted by the medical malpractice insurers who have responded to the Orders?
- d. Given the experiences in the medical malpractice liability insurance marketplace in the past year, does the department believe that the New Jersey Medical Malpractice Reinsurance Recovery Fund should be reactivated?

2. The individual health insurance market (from which individuals or families purchase coverage directly from an insurer or HMO) is struggling in the State. Those insureds who are covered by individual purchased plans are disproportionately high risk and high cost, resulting in an unstable market and high premiums. According to the Rutgers Center for State Health Policy, the New Jersey Individual Health Coverage Program in 2002 covered 82,383 persons, a decline of 103,747 or 55.7 percent, from a total 186,130 covered in 1995. However, this trend of rising premiums and a struggling economy has led to more uninsured individuals who are unable to afford individual health insurance policies.

- **Questions:** a. What has the department done in response to the struggling individual

## Discussion Points (Cont'd)

- health insurance market? Have any plans been formulated to address the problems currently faced by this market?
- b. Pursuant to P.L. 2001, c.368, health insurers were directed to offer an essential services or "bare bones" policy as part of the Individual Health Coverage Program. How many of these basic policies have been sold and how many persons are covered under this policy?
3. The automobile insurance reform legislation currently being considered includes a provision providing that the New Jersey Property-Liability Guaranty Association will run off, manage, administer and pay claims asserted against the Unsatisfied Claim and Judgment Fund (UCJF). When the UCJF was charged with reimbursing automobile insurers for medical expense benefits in excess of \$75,000 per person per accident, the amount of medical expense benefits provided on a per person per accident basis was unlimited. Subsequently, in 1990 a \$250,000 limit was imposed through legislation. The UCJF assessed insurers to reimburse insurers for the medical expense benefits paid.
- **Question:** What is the estimated amount that will be assessed to insurers in each of the next five years? What is the total amount of medical expense benefit claims, both current and anticipated future claims, at this time? The amount due on this debt in each of the next five years is approximately what percent of the annual premiums of property/casualty insurers which are to be assessed for that debt?
4. State Farm Indemnity Company (State Farm), which insures approximately 730,000 New Jersey automobiles, is in the process of withdrawing from the automobile insurance business in this State. Over the next two years, as part of the withdrawal process, State Farm will nonrenew approximately 96,000 vehicles. These vehicles will have to be insured with other insurers in a marketplace that is losing, rather than gaining, automobile insurers. This does nothing to alleviate the public perception that there is an availability problem with automobile insurance. Good drivers with good driving records are reporting that they are unable to obtain insurance in the New Jersey marketplace. Moreover, the "take all comers" provisions of the automobile insurance laws have exacerbated the availability problem.
- **Question:** a. Please detail the actions of the department in addressing this availability problem. How many insurers are currently exempt from the "take all comers" provisions and therefore not required to write new automobile insurance? How many automobiles does each of the exempt insurers currently insure?
  - b. Have any other automobile insurers, other than State Farm, been authorized to non-renew a portion of their business? Please provide a list of automobile insurers who have filed to withdraw from the State in the last five years.
5. The department implemented the "Last Chance to Get Legal" program in FY 2003. Specifically, the "Last Chance" program provided uninsured motorists with the opportunity to purchase automobile insurance without paying the underwriting surcharges usually imposed for driving without automobile insurance. According to the information available on the department's web site, uninsured motorists could save between \$115 to \$1300 under the program. To be eligible, motorists were required to buy coverage from the Personal Automobile Insurance Plan (PAIP).
- **Question:** What was the duration of the "Last Chance" program? How many motorists responded to the program and obtained insurance during this amnesty period?

## Discussion Points (Cont'd)

Please describe any additional measures currently being taken by the department to insure uninsured motorists.

6. Assembly Bill No. 75 is currently awaiting the Governor's signature. That legislation, the "New Jersey Home Ownership Security Act of 2002," prohibits certain abusive lending practices commonly known as "predatory lending," directs the Department of Banking and Insurance, in consultation with the Divisions of Consumer Affairs and Civil Rights, to develop and implement a program of consumer education to protect vulnerable consumers against predatory lending practices, and provides that the department and the Division of Consumer Affairs shall enforce the provisions of the legislation.

- **Question:** a. Please detail the department's current outreach and consumer education programs designed to reduce instances of predatory lending. What has been the department's enforcement role to date with regard to abusive or predatory lending practices.
- b. Please describe any new or expanded duties the department anticipates under Assembly Bill No. 75. Does the department anticipate that it will need additional staff to assist in its enforcement and consumer education duties?

7. On September 17, 2002, the department opened the Newark Consumer Center, a satellite office providing assistance to consumers concerning banking, insurance and real estate issues. At the Center, department staff is available to answer questions and take formal complaints. According to a press release dated September 17, 2002, future programs will be offered on such issues as insurance and Medicare fraud, identity theft, predatory lending and home-repair scams.

- **Questions:** a. Please comment on the success of the Newark Consumer Center thus far. How many department staff are expected to work in the Center? Will additional employees need to be hired to staff the Center?
- b. Please list any additional consumer initiatives that have been established by the department in FY 2003. What are the department's goals concerning consumer awareness for FY 2004?

## Background Paper: The "New Jersey Home Ownership Security Act of 2002" - Protections For Consumers From Abusive or Predatory Lending Practices

### Introduction

Assembly Bill No. 75 (hereinafter referred to as "A-75") is currently awaiting the Governor's signature. That legislation, the "New Jersey Home Ownership Security Act of 2002," prohibits certain abusive lending practices commonly known as "predatory lending," directs the Department of Banking and Insurance, in consultation with the Divisions of Consumer Affairs and Civil Rights, to develop and implement a program of consumer education to protect vulnerable consumers against predatory lending practices, and provides that the department and the Division of Consumer Affairs shall enforce the provisions of the legislation.

### What is Predatory Lending?

"Predatory lending," has become shorthand for describing a variety of lending practices that may be disadvantageous to borrowers. Abusive or predatory lending - whether undertaken by creditors, mortgage brokers or home improvement contractors - may involve fraud or deception, manipulating borrowers through aggressive sales tactics or taking unfair advantage of a borrower's lack of understanding about loan terms. These practices occur most frequently in the subprime lending market and target lower-income and minority borrowers.

The term "predatory lending" covers a potentially broad range of behavior and does not lend itself to a concise or comprehensive definition. However, predatory lending typically involves at least one, and perhaps all three of the following elements:

- ▶ making unaffordable loans based on the assets of the borrower, rather than on the borrower's ability to repay an obligation ("asset-based lending");
- ▶ inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced ("loan flipping");
- ▶ engaging in fraud or deception to conceal the true nature of the loan obligation from an unsuspecting or unsophisticated borrower.

Some of these practices are already clearly illegal and can be dealt with through effective enforcement of both federal and State law. However, other practices are more subtle, involving the misuse of lending practices. With the imminent enactment of A-75, New Jersey joins approximately 22 states that have taken affirmative steps to eliminate such practices in the mortgage lending arena.

### Prohibited Practices in the Making of "Home Loans"

A-75 prohibits certain practices in the making of home mortgage loans. A "home loan" is defined as a loan, including an open-end credit plan, other than a reverse mortgage transaction, secured by a mortgage on real estate on which one to six dwelling units are located or are to be located, or secured by a security interest in a manufactured home, which is to be used by the borrower as the borrower's principal dwelling. Practices prohibited with respect to all home loans include the following:

- financing of certain credit insurance premiums or debt cancellation agreements;
- recommending or encouraging default on an existing mortgage loan;

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- charging a late payment fee in excess of 5% of the amount of the payment due and other prohibitions;
- acceleration of the indebtedness at the creditor's sole discretion; and
- charging a fee for information concerning a borrower's payoff balance.

### Prohibited Practices in the Making of "Covered Home Loans"

In regard to covered home loans, "flipping," or the refinancing of a loan that was consummated within the prior 60 months and charging additional fees with no reasonable, tangible net benefit to the borrower, is prohibited under A-75. The legislation defines "covered home loan" as a home loan in which:

- the total points and fees payable in connection with the loan, excluding either a conventional prepayment penalty or not more than two bona fide discount points, exceed 4 percent of the total loan amount, or 4.5 percent of the total loan amount if that amount is \$40,000 or less, and 4.5 percent of the total loan amount if the loan is insured by the Federal Housing Administration or guaranteed by the federal Department of Veterans Affairs; or
- the home loan is such that it is considered a "high-cost home loan" under the provisions of A-75.

The amount of a conventional prepayment penalty may be excluded from the points and fees calculation if the home loan (1) does not have an annual percentage rate that exceeds the conventional mortgage rate by more than two percentage points and (2) does not permit any prepayment fees or penalties that exceed two percent of the amount prepaid.

In order to determine whether loan discount points are "bona fide" and may be excluded from the points and fees calculation, they must meet the following criteria:

- be knowingly paid by the borrower;
- be paid for the express purpose of reducing, and which result in a reduction of, the interest rate or time-price differential applicable to the loan;
- in fact reduce the interest rate or time-price differential applicable to the loan from an interest rate which does not exceed the conventional mortgage rate for a home loan secured by a first lien, by more than two percentage points, or for a home loan secured by a junior lien, by more than three and one half percentage points; and
- are recouped within the first five years of the scheduled loan payments.

### Prohibited Practices in the Making of "High-Cost Home Loans"

With respect to the making of "high-cost home loans," A-75 imposes other restrictions in addition to the prohibited activities enumerated in conjunction with "home loans" and "covered home loans." Pursuant to A-75, "high-cost home loans" are defined as loans for which the principal amount does not exceed \$350,000 and which meet or exceed the rate threshold of the total points and fees threshold established in the legislation.



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Rate Threshold	Points and Fees Threshold
Annual percentage rate (APR) qualifies loan as a "mortgage" under federal "Home Ownership and Equity Protection Act of 1974" (HOEPA) - to qualify under HOEPA APR must equal or exceed 8% for first lien and 10% for junior lien.	Total points and fees exceed 5% when total loan amount is \$40,000 or more or the lesser of 6% or \$1,000, if loan amount is \$20,00 or more but less than \$40,000.

In determining the points and fees threshold, A-75 requires that the following items be included in the calculation:

- all items listed in the definition of "finance charge" pursuant to 15 U.S.C. s.1605(a)(1) through (4), *except interest or the time-price differential*, which include: any amount payable under a point, discount or other system of additional charges; service or carrying charges; loan fees, finders fees or similar charges; and fees for an investigation or credit report.
- all real-estate related charges listed in 15 U.S.C. s.1605(e), which include fees for: title examination, title insurance and surveys; loan-related document preparation; notaries; credit reports; appraisals; pest infestation or flood hazard inspections; and escrows for future payment of taxes and insurance.
- all compensation paid directly or indirectly to a mortgage broker, including a broker that originates a loan in its own name in a table-funded transaction.
- cost of all premiums financed, directly or indirectly, for credit life, credit disability, credit unemployment or credit property insurance or any other life or health insurance or payments financed for any debt cancellation or suspension agreement, except for insurance premiums calculated and paid on a monthly basis.
- the maximum prepayment fees and penalties that may be charged or collected under the terms of the loan documents.
- all prepayment fees or penalties in a refinancing if the creditor or an affiliate holds the note being refinanced.

For open-end loans, the points and fees are calculated by adding the total points and fees known at or before closing, including maximum prepayment penalties allowed under the loan documents, plus the minimum additional fees the borrower would be required to pay to draw down an amount equal to the total credit line.

Under the points and fees calculation, however, A-75 further provides that certain items are excluded from, and subtracted from, the overall calculation. Pursuant to the definition, "points and fees," shall not include the following items:

- title insurance premiums and fees, charges and premiums paid to a title insurance producer or company;
- taxes, filing fees, and recording and other charges and fees paid or to be paid to public officials for determining the existence of or for perfecting, releasing, or satisfying a security interest; and
- bona fide and reasonable fees paid to a person other than a creditor or an affiliate of the

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creditor or to the mortgage broker or an affiliate of the mortgage broker for the following: tax payment services; flood certification; pest infestation and flood determinations; appraisals; inspections performed prior to closing; credit reports; surveys; attorneys' fees; notary fees; escrow charges; and fire and flood insurance premiums, provided certain conditions specified by federal regulation are met.

If it is determined that a loan meets the criteria for a "high-cost home loan," A-75 further imposes the following restrictions:

NO BALLOON PAYMENTS	No balloon payments except when payment schedule takes into account irregular income of borrower.
NO NEGATIVE AMORTIZATION	No mortgage loan terms under which the loan principal balance will increase over time.
NO DEFAULT INTEREST RATE	No increase in the interest rate upon default.
NO ADVANCE PAYMENTS	Cannot require more than two periodic payments to be consolidated and paid in advance from the loan proceeds.
NO INCONVENIENT FORUMS	No inclusion of a provision that allows a creditor to require a borrower to assert any claim or defense in a forum that is less convenient, more costly or more dilatory for the resolution of a dispute than a judicial forum.
NOTICE REQUIREMENT	No lending without prior written notice, acknowledged in writing and signed by the borrower within three business days prior to loan closing, as required by federal regulation, that advises borrowers of the importance of certain consumer protections.
NO MODIFICATION OR DEFERRAL FEES	No charging of fees for modification or deferral of the loan.
COUNSELING REQUIREMENT	No lending to a borrower who finances points and fees, without first receiving certification from an approved third-party nonprofit credit counselor, that the borrower has received counseling on the loan transaction or completing another substantial requirement developed by the Department of Banking and Insurance;

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HOME IMPROVEMENT CONTRACTS	No direct payment to home improvement contractors out of the loan proceeds; the payment out of the loan proceeds must be to the borrower, jointly to the borrower and contractor, or a third-party escrow selected by the borrower.
FINANCING OF POINTS AND FEES	No financing of points and fees in excess of 2% of the total high-cost home loan amount.
REFINANCING OF EXISTING HIGH COST HOME LOAN	No charging of points and fees if the proceeds of a high-cost home loan are used to refinance an existing high-cost home loan held by the same creditor as note holder.
FORECLOSURE	No foreclosure by means other than the judicial foreclosure procedures of this State.

### Assignee Liability

As previously mentioned, with the enactment of A-75, New Jersey will join a group of approximately 22 states that, since 1999, have approved legislation to address and deter predatory lending practices. However, certain provisions of both Georgia's and New York's law, concerning the extent of assignee liability, were problematic for investors who might ultimately own "high-cost home loans" as part of a loan portfolio or structured finance transaction.

In January of 2003, several rating agencies, including Fitch Ratings and Standard & Poor's, publicly announced their concerns with these extensive assignee liability provisions. Standard & Poor's even went so far as to exclude any mortgage loans and manufactured housing loans governed by Georgia's law from any of its rated structured finance transactions. Georgia subsequently amended its "Fair Lending Act," to revise the provisions concerning assignee liability and enacted limitations on damages which may be assessed against assignees.

In an effort to avoid any such problems with the "New Jersey Home Ownership Security Act of 2002," certain amendments, made in consultation with, and at the direction of, leaders in the credit rating service industry, ensure that all non-high-cost loans covered under its provisions made in this State will continue to be rated by the leading credit rating services.

With respect to "home loans" pertaining to a manufactured home or for home improvements to the dwelling of a borrower, A-75 provides that the borrower may assert all affirmative claims and any defenses that the borrower may have against the seller or home-improvement contractor. However, any amount recoverable by the borrower against a creditor, assignee or holder are limited to amounts required to reduce or extinguish the borrower's liability under the home loan, plus the total amount paid by the borrower in connection with the transaction, plus amounts required to recover costs, including reasonable attorney's fees.

With respect to assignee liability under a "high-cost home loan," A-75 provides that a purchaser or assignee of such a loan is subject to any affirmative claims and defenses that could be

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asserted against the original creditor or broker of the loan unless the purchaser or assignee demonstrates, by a preponderance of the evidence, that a reasonable person exercising reasonable due diligence could not determine that the mortgage was a "high-cost home loan." Pursuant to A-75, a purchaser or assignee will have limited liability for damages so long as it is proven that the purchaser or assignee followed these due diligence procedures:

- the purchaser or assignee has in place, at the time of the purchase or assignment of the loan, policies that expressly prohibit its purchase or acceptance of assignment of any high-cost home loan;
- the purchaser or assignee requires by contract that a seller or assignor of home loans to the purchaser or assignee represents and warrants to the purchaser or assignee that either (a) it will not sell or assign any high-cost home loan to the purchaser or assignee or (b) that the seller or assignor is a beneficiary of a representation and warranty from a previous seller or assignor to that effect; and
- the purchaser or assignee exercises reasonable due diligence at the time of purchase or assignment of home loans or within a reasonable period of time thereafter intended by the purchaser or assignee to prevent the purchaser or assignee from purchasing or taking assignment of any high-cost home loan.

### Enforcement and Penalties

As part of its enforcement abilities, A-75 provides that the Department of Banking and Insurance shall conduct examinations and investigations and issue subpoenas and orders to enforce the provisions of the legislation with respect to persons licensed under or subject to the "New Jersey Licensed Lenders Act," P.L.1996, c.157 (C.17:11C-1 et seq.), and requires the submission of reports by persons originating or brokering high-cost home loans as required by the department by regulation.

If a person fails to comply with a subpoena issued by the department, the department may request a court order for the production of the requested information. Persons found in violation of provisions of the legislation may be subject to the following:

- a civil penalty of up to \$10,000 for each offense, 40% of which would be dedicated for and used by the department for consumer education through nonprofit organizations;
- license suspension, revocation or nonrenewal;
- permanent removal of an individual responsible for the violation from working in his present capacity or in any other capacity related to activities regulated by the department;
- an order to cease and desist any violation of this bill and to make restitution for actual damages to borrowers.

In addition, A-75 provides that the Commissioner of Banking and Insurance may enter certain temporary orders to prevent undue harm to borrowers pending completion of any investigation or formal proceeding. These provisions do not limit the authority of the Attorney General from instituting or maintaining any action within the scope of his authority with respect to the prohibited practices.

Finally, A-75 makes violations subject to the consumer fraud law and the penalties and enforcement provisions therein. In addition, a person who substantially violates the provisions of

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the legislation is liable to the borrower for: statutory damages equal to the finance charges agreed to in the home loan agreement, plus 10% of the amount financed; punitive damages, when the violation was malicious or reckless; and costs and reasonable attorneys' fees. The bill preempts any ordinance, resolution, rule or regulation of a municipality or county concerning abusive home loan lending practices.

### **Conclusion**

With the enactment of A-75, it is anticipated that all consumers and especially those most vulnerable, namely lower-income and minority borrowers, will enjoy enhanced protections from lending practices characterized as predatory and abusive.

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Individuals wishing information and committee schedules on the FY 2004 budget are encouraged to contact:

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