

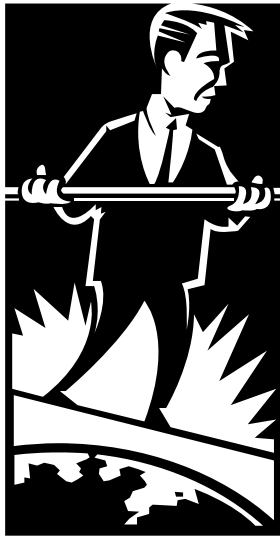
Do's and Don'ts

Market Conduct Exams: An Insurer's Perspective

By Mark Gardner

I recently had the dubious pleasure of coordinating a market conduct examination of two insurance companies.

An examiner from one of the largest states conducted the exam. While trying to simultaneously juggle the needs of the examiner and my internal clients, I came to the conclusion that there are essentially three phases to a market conduct examination exam, namely:



1. The preparatory phase;
2. The examination phase; and
3. The post-examination phase.

It was also clear that there are numerous do's and don'ts that successfully guide the examination process. This article provides an insurer's perspective of these three essential phases.

First, the background of the examination. The subjects of the examination were mid-sized property/casualty insurers that write various property/casualty lines in all 50 states. The exam was an "underwriting and rating" exam, thus no claim files were reviewed. Actually, the scope of the exam was quite limited insofar as only two books of business, and only policies issued out of the insurers' two offices located in the examining state, were reviewed. The exam was conducted by one examiner in the two in-state offices of these insurers, and it lasted approximately one week in each office.

The Preparation Phase

The process began innocently enough when a letter was received addressed to the Chief Executive Officer. The letter applied not to a single insurer, but to the entire group of insurers. The letter notified

continued on page 4

Fun stuff to do in New Orleans

New Orleans is so much more than the French Quarter.

Of course, you will want to check out the Quarter, since it's only a few blocks from the New Orleans Hyatt, site of the Year 2000 IRES Career Development Seminar July 30-Aug.1.

But here are a few other suggestions while you're in one of the world's great party cities. For information on seeing any of these attractions, contact New Orleans Tours at 504-492-0560. A few examples:

The Battlefield Cruise, the Aquarium, IMAX Theater & Zoo, River & City Combo Tour, Historic Plantation Tour, Swamp Tour, Garden District Tour, Cities of the Dead/Cemetery Walking Tours, Lake Pontchartrain, Shopping on Royal Street, Tour of the Superdome, Mardi Gras Museum, St. Louis Cathedral...and more.

Among the many web sites for checking out New Orleans, our favorite is <http://www.alanet.com>



JULY 2000

So long, Prez Angela	2
Continuing Ed news	7
Insurance "brain teasers"	9
Profile: West Virginia Ins Dept	10
When Disaster Strikes	12
Regulatory RoundUp	16
Scenes from IRES regulator school	18
Upcoming NAIC educational programs	19

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From the President

Meet me in New Orleans

I'm getting excited. I've seen the advance brochure and believe that we are in for the time of our lives! Our Education Committee, CDS Chair, and Section Chairs have put together a terrific program. It seems that this CDS will cover everything from the Internet to the Frankel Case. It took us awhile to nail down just the right selection for our Commissioner's Roundtable. We've got the NAIC President, Commissioner Nichols, Kentucky; our host is Commissioner Brown, Louisiana, Commissioner Pickens, Arkansas is joining us; and my boss, Commissioner Long, North Carolina, is coming along to keep me out of trouble!



It's been a fruitful year for the organization; however, there's still much to be done. Our organization has changed quite a bit since I joined. When I think back over my year serving as president, one question comes to mind: "How in the world did I get into this situation?"

I had a nice visit with the primary culprit the other day. Some years ago, Jerry Polenz, who was my boss at the time, asked me to do a presentation on market conduct at the 2nd CDS. I didn't have the heart to refuse as I valued my job. At this CDS, I really got a chance to see some of the founding members upclose. I remember them vividly as they were arguing/discussing the path of IRES. It seemed that they were in every corner of the hotel; you could not get away from them.

At this same CDS, I ran into one of the members who had just finished participating in the board meeting. It must have been a heck of a meeting as this member forcefully told me that the organization had to move forth and that I needed

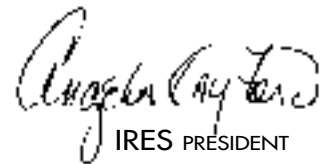
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to get involved. I had never met this person before and at first thought that she was talking to someone standing behind me. This person (who is now a dear friend) had a heavy German accent (guess who). I'm a southern girl and had a few problems understanding what she was saying. I remember thinking at the time that this must be some organization to get folks so riled up!

I conducted another presentation at the 3rd CDS. It was then that I got to know David Chartrand. He politely mentioned that if I was going to continue to do presentations for the organization, that it would be good if I was a member. I could not argue with his logic (I never got a chance since he was talking so fast); hence, I joined. I'll give David credit as from that moment he has called, faxed, and e-mailed me to death. I sit in fear of the newest technology that David might discover. I'm expecting him to show up on my television any day now.

I joined IRES and I guess the rest is history. I thought that I would tell you my story as I am now one of the fanatics. I constantly talk to my fellow regulators about joining IRES. It's the best thing that has happened for state regulators in a long time. I also encourage you to join and participate as IRES needs and will continue to need new members and ideas.

After all, any organization is only as good as its membership. Meet me in New Orleans; we'll discuss it further!



IRES PRESIDENT

EDITOR'S NOTE: We would like to express our thanks to Angela Ford for her support and contributions to the publication over the past year. Angela, we hope you'll continue to grace our pages with articles of interest to IRES members.

Watching the Web

The following are data and predictions from the "P&C Insurance Death Spiral Study" conducted by Forrester Research as reported in the May 22, 2000 edition of "WebFinance":

Percent of surveyed insurers ^a that said they planned to offer real time quotes on their Web sites by year end	60%
Percent that plan to sell insurance through quoting agents such as InsWeb by year end.....	66%
Percent that think agents will be phased out as a result of the Web....	15%
Predicted online annual U.S. sales of auto insurance in the year 2004 ..	\$11.0 billion
Current online annual U.S. sales of auto insurance	\$1.2 billion
Predicted Percent of Personal Lines Insurance Purchased on Web in 2004.....	10%
Current Percent of Personal Lines Insurance Purchased on Web.....	1-2% ^b

^a Based on a survey of 40 insurers

^b Based on various industry estimates, not on Forrester data

Do's and Don'ts of market conduct exams

continued from page 1

the CEO that the exam would be commenced within a year (most other states give much shorter notice), and requested information relating to a whole host of topics, including the names of all our insurers doing business in the state, the locations of all offices located in the state, the descriptions of the programs written in the state, and the name of the person who would act as the “Examination Coordinator.”

These requests for information gave rise to the first set of “do’s” and “don’ts.” **Do** provide information requested within a timely basis. **Don’t** ignore it, forget about it or ask for an extension at the last minute. Also, it is not a good idea to keep the existence of the letter and the information requests to yourself. **Do** advise business management immediately, even though — as in our case — the exam did not begin until 13 months after the initial letter. **Don’t** make it the sort of surprise that the business people typically despise.

When responding to the Department, **Do** ask for the immediate “dismissal” of any insurers that should not be subjected to the exam, *e.g.*, surplus line insurers, reinsurers, etc. In our case, we asked for and received dismissals of our two reinsurers and our two surplus line companies. **Don’t** come to a last-minute realization that you need to request a dismissal. (Some states will not honor any requests for dismissal, but many do.) You cannot expect an Insurance Department to disrupt its future examination workload in order to honor your tardy request.

The original letter from the Department may indicate that a second letter formally announcing the dates of the exam will be forthcoming. After the second letter notifying you of the actual commencement date of the exam arrives, **Do** prepare for the

exam by compiling the statistical materials and documents requested. Also, make sure you provide supplies and a livable work space for the examiner(s). **Don’t** waste the examiner’s time by not having everything available when the exam starts since hourly exam rates can be steep. **Do** be understanding with the affected internal staff, business people and underwriters since the exam is likely to disrupt their operations and daily schedules. **Don’t** berate, badger and hassle them, or impose unrealistic deadlines.

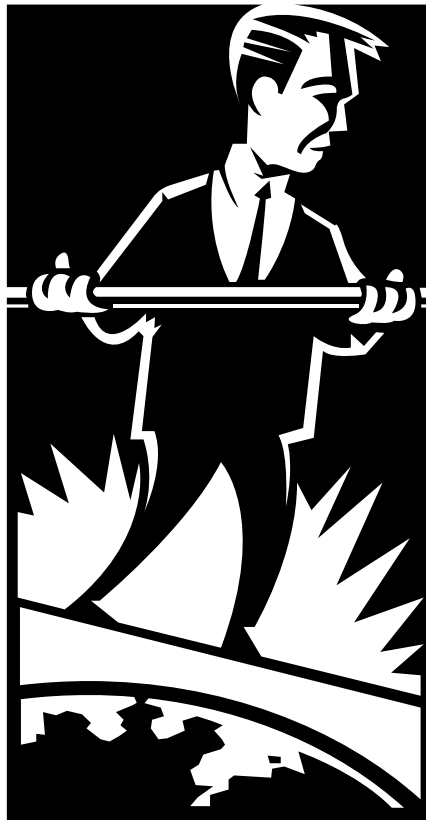
If the Department asks to perform the exam on-site at certain locations, **Do** be as flexible as possible in agreeing to the request. **Don’t** automatically reject the request just because it isn’t convenient for a single individual, even if that person is the head of the office in which the Department wishes to conduct the exam.

Do make sure you evaluate the types of market conduct requirements with which your insurer will be asked to comply. **Do** review the applicable law in advance and assess the various regulatory and compliance requirements that will apply to your company. **Don’t** go into the exam without knowing the various requirements applicable to your company.

Another frequently overlooked task that helps to smooth the way for a successful exam is to discuss it fully with all affected personnel in advance of the arrival of the Department’s staff. In our case, we created an internal task force consisting of me — the regulatory lawyer — the managers of the two field offices and the two vice presidents back in the home office who oversaw the lines of business that were subject to the exam. The examiner conducted the exam at the offices of the two insurers being examined, so we held occasional meetings both before and during the exam to monitor the progress of the exam.

Do dispel all myths and apprehensions about

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Doing market conduct exams the right way

continued from previous page

insurance department employees. All staff with whom the examiner will be communicating should be told that insurance department personnel are not representatives of the FBI, or the Attorney General's office, or government employees looking to be bought off. **Don't** create or compound a perception that most examiners are bland bureaucrats intent on nit-picking your organization to death. I have found that many employees have no idea of what to expect from state examiners, so a brief "mini-education" session can be both valuable and reassuring.

Finally, **Do** request extensions from the Department when certain types of information or documentation cannot reasonably be retrieved within the given time frame(s) originally provided by the Department. **Don't** ram unrealistic deadlines down the throats of your business people because this will not only cause hardships and ill will between you and the business people, but it will also alienate the representatives of the Department in the event deadlines cannot be met.

The Examination Phase

Often, examiners will be ensconced in your company for weeks – and sometimes months. **Do** provide them with a comfortable workspace, computers with the requisite software and hardware capabilities, and Internet and e-mail access. **Don't** direct the examiner to a dank, poorly lit hole-in-the-wall, or place the examiner in an office with company personnel that lacks privacy.

When examiners arrive at your office, they are likely to be unfamiliar with the lay-out of your office. **Do** be hospitable by identifying the location of the employee cafeteria, the lavatory, inexpensive local

restaurants, etc., and by introducing him/her to anyone within his immediate workspace. **Don't** just lead the examiner to an office and ignore her. It is always an awkward situation when a newcomer joins an ongoing, active office environment. By welcoming examiners and trying to establish them as short-term members of the office, you will make everyone feel more comfortable.

Since the examiners will be requesting information on a variety of subjects, it often makes sense to identify *one* primary contact person who can coordinate the examiners'

contacts with others. This person can be the same "coordinator" described earlier in the article, or another person who is on-site and reports to the central coordinator. The goal is to provide the examiner with a person who is located nearby and can be responsive to the examiner's needs and questions. **Do** identify one primary contact person with whom the examiner can meet on a daily basis to respond to requests, discuss the progress of the exam, etc. **Don't** distribute decision-making

authority equally to several people and allow them all to be involved in the exam. This creates a confusing mess.

It is also important to select the right person to be the primary contact. **Do** designate a person who has knowledge of the programs under scrutiny and who has the requisite authority to make decisions. **Don't** designate someone who is unfamiliar with regulatory compliance or whose decisions will be overruled or countermanded. The right person necessarily must be someone who can meet with the examiner at a moment's notice. Therefore, **Do** designate someone

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Don't waste the examiner's time by not having everything available when the exam starts, since hourly exam rates can be steep. . . Don't berate, badger and hassle examiners or impose unrealistic deadlines.



The do's and do not's of market conduct

continued from previous page

who is on-site. **Don't** designate someone who is in another office, much less in another state.

Market conduct exams may last for weeks, or even months. During the course of these exams, certain staffing changes may occur. As early as possible, **Do** designate a substitute for the primary contact person in case the first individual leaves the firm, suffers an extended illness, etc. **Don't** allow all knowledge of the exam to reside with one person. Ignoring this rule may leave you facing a significant information void.

At about the same time as examiners are beginning the exam – if not prior to their arrival – the various departments that may become involved with the exam should be advised of the examiner's arrival. **Do** notify individuals in other departments, *e.g.*, Actuarial, Accounting, Claims, etc., who may need to become involved with the exam that they will essentially need to be “on call” and reachable to answer questions and produce documents quickly. Making the effort to have the appropriate people available will pay dividends by expediting the exam and reducing the amount of expense chargeable to your company.

As the exam progresses, it is useful to inform senior management of the examiner's initial findings. Both to prevent those surprises that senior management dislikes and to immediately identify any likely sources of serious problems, it makes sense to send occasional e-mails to senior management. E-mails should be short, bullet-point memoranda that briefly summarize the progress of the exam. In addition, you should be aware that an officer from the home office may be required to attend some of the more important meetings at the company.

Now to perhaps the most important helpful hint in this article. During the exam, examiners may uncover certain information that places your company in a bad light. **Do be honest and truthful when answering questions and producing documents.** **Don't** attempt to “reconstruct” missing documentation. **Don't** try to conceal information or evade requests for information—you will ultimately be discovered! Your most important tools during an exam are integrity and credibility — don't lose them!

Similarly, **Do** respond to all requests for documentation and information quickly so as not to waste the examiner's time and your company's money. **Don't** delay or procrastinate. To delay may create the appearance of stonewalling at worst, confusion and disorganization at best.

During our examination, the examiner demonstrated very organized, efficient work habits. He began the exam with an initial meeting involving all affected players. He outlined what he would be reviewing, the duration of the exam, and the areas under examination. His attitude was cordial and cooperative. He also displayed occasional flashes of humor, describing himself as a “compassionate conservative regulator,” a description, it turned out, that was not too far off the mark.

Most importantly, the examiner was not dogmatic, overzealous, or unreasonable. When a senior executive produced potentially damaging information, the examiner responded to the revelations in a measured manner. He was prudent and experienced enough to understand that such revelations may be a cause for concern, but did not merit initiating a witch hunt. Similarly, when it was clear that one young underwriter had failed to document underwriting files as well as he should have, the examiner did not attempt to single out the person for blame or ridicule. He used the occasion as a means of educating the underwriter to improve his job performance.

Just prior to the last day of the exam, the examiner scheduled an interactive discussion of all of his findings. The session created an opportunity for the insurer to hear the “charges” made by the examiner, and defend itself. In some instances, it was clear that lapses had occurred and no defense was appropriate. In others, there were reasonable explanations offered for the actions taken or not taken.

Finally, on the last day of the exam, the examiner scheduled an “exit meeting” in order to review the violations and the timetables for remediating same. In this meeting, the examiner again demonstrated strong organizational skills by establishing specific deadlines for the accomplishment of certain goals.

continued on page 8

Do's and don'ts of market conduct exams

continued from page 6

The Post-Examination Phase

After the examiner leaves the examination site(s), there will often be a post-examination period in which certain remedial actions must be taken. Typically, rate filings will have to be made, overcharges will have to be refunded, underwriters may have to receive training in specific areas and other corrective changes will have to be implemented.

Do respond in a timely fashion to any post-exam timetables established by the examiner. **Don't** try to delay and drag out the remedial period in the hope of wearing the examiner down. The modifications he has recommended will have to be made sooner or later. Since some states will have either mandated deadlines for the completion and submission of the final examination report, it may be particularly disingenuous to procrastinate. For example, if the report must be finalized by the Department within 60 days after the examiner leaves the exam site, then to delay may result in a sudden time crunch at the end of the 60-day period.

Depending upon the examiner's findings and the extent to which your company is out of compliance, you may be able to establish certain systems or processes for the future that will prevent the same compliance deficiencies from arising. For example, in the event that underwriters are not adequately documenting their files and providing justification for certain underwriting judgments, it may be possible to coordinate with the training department to create appropriate training classes for new underwriters. Similarly, if existing rate filings did not reflect the rates actually being charged, it may be possible to coordinate with the Legal or Compliance Department to schedule rate filings to be made at predetermined times in the future.

When the first draft of the examiner's report is sent to you, **Do** make recommendations to clarify any findings that are not entirely accurate or may be misleading. In the event, however, you are in a position of extreme weakness because of numerous compliance lapses, **Don't** push too hard!

Finally, some insurance departments schedule face-

to-face meetings at department headquarters. **Do** be prepared for these meetings by formulating an "action plan," which describes the corrective compliance actions that have been implemented.

Conclusion

In short, an examination need not be a painful experience for you, your company, or the examiners. Suggestions from an outside, objective observer – like an insurance department examiner – very often can help you improve your company's operations. Following the few simple do's and don'ts outlined in this article will help ensure that your examination: (1) proceeds with minimum disruptions, (2) is not extended needlessly, and (3) results in a final report that accurately portrays your company's strengths and weaknesses. Although much of the advice outlined in this article may seem like nothing more than good old-fashioned common sense, you'd be amazed at how often common sense takes a back seat in the examination process.

Mark Gardner, a former Deputy Superintendent of the New York Insurance Department, works as an insurance attorney.



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And remember: "The Regulator" newsletter is free to all IRES members.



Here are some insurance-related puzzlers. Decipher the hidden meaning of each set of words.

By Kashyap Saraiya and Wayne Cotter

Answers on page 14.

West Virginia keeps close to the companies it examines, and the consumers it serves

By Scott Hooper

REGULATOR staff writer

The key to successful business relationships, they say, is to know who you're dealing with. Companies, know your customers; consumers, know the company you're buying from.

If that's true, then we should all move to West Virginia.

Of the 1,250 insurers licensed to do business in the state, just 24 are domestics, and they tend to be small companies that sell mostly — or entirely — in-state.

"We have a very close relationship with our domestics," said Jeffrey VanGilder, director of the Financial Conditions Division for the West Virginia Department of Insurance.

"If we have a problem, we bring in top management and work through the issues. In that respect, we have a very close working relationship with all our domestics."

Health care

Take health care.

West Virginia's population is the nation's oldest — a median of 38.6, compared with 35.2 for the nation as a whole, with 15% of the 1.8 million residents older than 65 (a figure that's expected to rise to about 25% by 2020).

That fact alone puts health issues, from managed care to Medicare and Medicaid, on the state's front burner.

"Health care issues take up about 80-90% of our time," said VanGilder.

"We're very active with the HMOs and quality-of-care issues and services to consumers. We are very, very active in that area," he added.

"Plus, in 1995 we passed a law requiring all HMOs to be domestic, so that we have closer control."

Aside from one small Maryland plan that was grandfathered in, all managed-care companies are indeed based in-state. Following three recent acquisitions, the number of HMOs is down from seven to four. Despite all the national attention to HMO abuses (or perhaps because of the attention paid by the Depart-

ment) West Virginia consumers seem to be well served by their local plans.

"We've had a very low percentage of complaints in the managed-care area from consumers," VanGilder said. "A lot of the complaints concerning HMOs come from providers, with respect to slow pay and this type of thing. We track that very closely."

First oak tree on the right

One of the reasons the department is able to keep such close track of its domestic insurers is that many of them are really small.

"I examined one company and the directions were, 'You go down this road until you pass this big oak tree on the right,'" VanGilder recalls.

The really small ones are farmers mutuals, generally offering only fire insurance, and then with a \$10,000 limit.

"We have 12 of those left, and one of them does about \$12,000 a year in premiums," VanGilder said. "We've been trying to encourage it to merge. I think it had one claim over the three-year period of the last examination. We've been successful in getting some of the smaller companies to merge, but we still have three very small ones."

These companies are closely held, to put it mildly — "The president is the agent, that type of thing," said VanGilder. "But they're local, and they have a good working relationship with their customers."

Most insurers prefer traditional urban customers, with a fire hydrant no more than 1,000 feet from the house. In rural areas, the rates tend to get pretty high, while the farm mutuals work to keep rates down. At the same time, the Department is concerned with mutuals' geographic concentration. One big storm could wipe them out.

"We did have several windstorms in '98, a lot of hail damage, and on account of that we made several of our farm mutuals strengthen their reinsurance."

Small as they are, they don't want to be merged out of existence. They don't cause regulators much of a problem. And they serve a very real need, writing fully 20% of the state's homeowners policies, especially in rural areas.

continued from previous page

“As a general rule, our farm mutuals are very stable from a financial and an operational standpoint,” VanGilder said. “We just finished up an exam of one of them, and their claims process took five days. The claims person goes out and investigates and settles up.”

Few weather woes

One thing that West Virginia doesn't have much concern about is natural catastrophes.

Earthquakes? Not that anyone can recall. Tornadoes? Not a big threat.

“Commissioner Clark has made the observation that West Virginia is probably the least prone state to natural disasters,” said VanGilder. “The only thing we have to worry about is flooding, and that's covered by FEMA. We don't get much hurricane damage, and very few tornadoes.”

One of the few risks that West Virginians face that those in other states generally don't is its legacy of mining, with cases of black lung and the like.

The state also has its share of rural poverty, with pay scales that make it tough to hire and retain examiners. However, West Virginia does have some of the prettiest countryside in the nation, as well as some of the lowest average housing costs.

VanGilder usually manages to get qualified people — his division currently has two CPAs, and over the

years he's had a goodly share of CFEs and CIEs. But as soon as they're trained, they often leave.

The Legislature just last year approved hiring contractors, and that should help fill in the gaps.

The department generally relies on other states to examine their domestic companies operating in West Virginia, although if they have a specific issue, they'll look at them. Indeed, none of the three current examiners even lives in the state, and travel has taken them as far afield as Springfield, Ill., and Birmingham, Ala.

“A lot of the market conduct area is taken care of by our consumer division and our legal division, by a cease-and-desist order or something like that, taken care of in summary fashion,” VanGilder explained.

One might wonder whether a small state with a close relationship with its small, local companies would have a hard time getting the attention they deserve from the large national insurers operating within its borders, but VanGilder says that hasn't been much of an issue.

“We had a \$50,000 claim recently on Allstate, and we got their attention,” he said. “We do bring in some companies, both domestics and nondomestics, on issues. I mean, if there's a problem, we bring the companies in and we try to resolve it as quickly as possible.

“We're a very hands-on department.” ■

West Virginia Department of Insurance

Commissioner: Hanley C. Clark

Market conduct exams handled by: Financial Conditions Division.

Size of staff: 4 examiner positions/12 in division/60 in Department

Contractors: Recently authorized, will begin using contractors soon.

Domestic/total companies: 24/1,250

Confidentiality: Exam reports and orders are public upon completion and approval by the commissioner; hope to put them on the Web in the future.

Contact: Jeffrey VanGilder, director, Financial Conditions Division, 304-558-2100, vangilj@wvnm.wvnet.edu



Hanley Clark

When Natural Disaster Strikes: Seeking Federal Remedies

By Ross J. Davidson, Jr.,
USAA

The federal government regularly provides substantial financial and logistic support through its various disaster relief programs to help communities, businesses and citizens prevent, reduce and recover from losses due to natural disasters. Under current budget rules, most of the expenditures for disaster relief are outside of the federal budget and thus must be specially appropriated by specific Congressional action in the event of a disaster.

A Congressional study of federal financial assistance for natural disasters revealed that, over a 20-year period ending in 1992, federal disaster assistance totaled over \$140 billion – an average of \$7 billion per year. The study also revealed that, contrary to common belief, most federal recovery assistance is not used to repair infrastructure (roads, bridges, etc.). The bulk of federal disaster recovery expenditures went to farmers, businesses and individuals. Only 13% was for what could be called infrastructure.

The private insurance market is also a major source of funds for disaster recovery. During the same period referenced above, U.S. insurers paid over \$80 billion in disaster-related claims. And subsequent events such as the Northridge quake, Hurricane Floyd and others have resulted in tens of billions of dollars of recovery payments.

Predictions of future possible disasters do not offer much hope for an end to the personal, community and national loss that can come from such disasters. The silver cloud of our booming economy comes with a dark lining. Population and wealth concentration in disaster-prone areas are increasing dramatically. And scientists predict one or more major disasters will happen somewhere in the U.S. over the next few

decades. Several possible disaster scenarios could result in greater losses than we have experienced to date.

Such predictions have motivated a close examination of the U.S. disaster preparedness and recovery system. Many have questioned whether the U.S. disaster system is or can be prepared for the more devastating events that could happen. Others say that we should not worry – there is plenty of capacity to handle a major shock.

The real answer lies between these extremes. Concerns over national disaster preparedness can be summarized in four principal areas:

1) There is not enough private risk-bearing capacity that is willingly dedicated to and available for disaster relief for any one major event or area, leaving taxpayers to make up the deficit.

- After Hurricane Andrew, the Insurance Services Office (ISO) evaluated the capacity of the insurance industry to handle a large event that hit a highly populated area, such as would have been the case if Andrew had passed 40 miles north through Miami. The possible insured losses from such an event could have exceeded \$50 billion and caused up to 36% of all insurers in the U.S. to fail, according to ISO. Federal assistance would have been required to pay for losses that otherwise could have been covered by insurance. A lot has happened since then to alleviate that condition, but the capacity of some regions to absorb a truly large disaster without major market dislocations is still in doubt.
- California is a good example. It has been estimated



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that the California Earthquake Authority that provides over 70% of all earthquake insurance in the state would be obligated to pay approximately \$6 billion in claims if an \$80 billion quake were to occur somewhere in California. Little of the remaining \$74 billion is covered by private insurance. Other areas of the country such as the 23-state New Madrid fault region are in a similar quandary.

2) Existing public policies and programs foster inefficient use of resources, discourage or prohibit prudent preparedness and reward or facilitate poor risk decisions to the detriment of taxpayers. Examples include:

- Federal assistance to rebuild in areas exposed to repetitive loss from disasters such as floods, hurricane, mudslides, etc.
- Inadequate building codes and land use restrictions.
- Federal assistance to individuals, businesses and communities that can, but have chosen not to, purchase available private insurance.
- Federal tax policies that tax premiums that should be accumulated over the long term to pay for infrequent major disasters and thus increase the cost of providing disaster insurance and reduce the willingness and readiness of insurers to cover major disasters.
- Federal subsidies through federally or federally backed insurance in high-risk areas and for high-risk properties.
- State limits on insurance rates, policy structures and underwriting policies that result in less available or less adequate private insurance and engender the need for state and federal programs to compensate.

3) State insurance mechanisms are often not adequately funded for the extreme exposures they bear.

- A number of states have set up mechanisms to assist property owners in high-risk areas that are inadequately served by the private insurance market to obtain insurance coverage. These mechanisms are organized in various ways to either provide policies directly with funding from the private market, to allocate mandatory participation by insurers in certain markets, or to provide reinsurance to private insurers. In many instances these mechanisms have

limited resources that are far less than the maximum probable loss to which the mechanism is exposed.

- Some of these mechanisms are taxed under the U.S. tax law. The resultant tax on income diverts a significant amount of capital away from the mechanism that otherwise could be available for paying catastrophic losses.
- 4) Many who could purchase private insurance are not doing so, leaving federal and state government and, ultimately, the taxpaying public to pay for costly disaster recovery.
- Experience in the North Dakota floods is a good example. It was known well in advance that accumulated snowpack during a hard winter would result in massive spring flooding. FEMA conducted an extensive public education campaign, encouraging people to buy federal flood insurance. But many did not and instead relied on the anticipated federal assistance to recover. This phenomenon is not unique to North Dakota. Property owners in several states, such as North Carolina, received federal assistance after sustaining substantial uninsured flood damage from Hurricane Floyd. Yet, in most instances, flood insurance was available and could have been purchased.
 - Some segments of society have come to rely on and even expect federal assistance to fund the risk associated with their choices. As noted above, 87% of federal disaster recovery aid goes to farmers, small businesses and individuals. Many of these risks are insurable in the private market.

Legislation introduced in the 106th Congress is intended to deal with some of these issues. The chart on page 15 provides a brief description and the status of some of these proposals. Two have significant momentum at this point. They are:

- The Policyholder Disaster Protection Act (HR 2749/S 1914) would allow insurers to set aside a portion of policyholders premiums in segregated tax-deferred accounts dedicated to pay claims from individuals and businesses arising from future major disasters such as windstorms (*e.g.*, hurricanes, tornadoes), earthquakes, volcanic eruption, tsunami, floods, tornadoes, hail, winter catastrophes and fire. Contribu-

continued on next page

When Natural Disaster Strikes

continued from previous page

tions to these accounts would be deductible for federal income tax purposes and insurer withdrawals from the accounts would be included in the insurer's federally taxable income. The legislation sets forth limits on an insurer's contributions to the fund, sets forth standards for safe investment of the funds and defines the amount and nature of losses above a threshold that qualify for reimbursement out of the funds.

- The Homeowners Insurance Availability Act (HR 21/S 1316) would have the Treasury or a quasi-public organization design, sell and administer catastrophe derivative contracts (called reinsurance in the legislation) to state insurance programs, insurers, reinsurers and other "interested parties." The contracts would pay the holder a sum certain upon the occurrence of residential property losses in a state or region that exceeds a defined threshold. The Senate version of this bill would accomplish this through a quasi-public/private agency and the House version would delegate administration to the Treasury Department. Both would be funded from the accumulated proceeds from sale of the contracts over time and would allow access to Treasury borrowings for losses that

exceed accumulated capital. Contractholders benefiting from such federally funded payments would have to continue in the program until such borrowings are repaid. The Senate version also sets forth standards for mitigation of disaster losses and provides a mechanism for funding such activities. The legislation delegates to the administrator of the program authority and discretion for the design and administration of the contracts within broad parameters.

Some believe that these proposals could co-exist in practice since the first enhances private capacity and willingness to cover natural disasters and the second provides a federal backstop in the case of a major disaster and is intended to avoid crowding out private markets. Others are fundamentally opposed to federal involvement in insurance markets and view the passage of federal reinsurance legislation as being unnecessarily intrusive, unfairly competitive with, and potentially discouraging of innovation in, private property insurance markets. Some supporters of each bill who believe Congress may only pass one disaster-related bill view the passage of the other as a threat to the legislative success of their favorite solution. Congress may need Solomon's wisdom to sort this one out.

See chart on current federal disaster legislation — p. 15

ANSWERS: BRAIN TEASERS

1. Life insurance
2. Insurance underwriting
3. Fly-by-night insurance company
4. Capital markets
5. Property insurance covers damage to property
6. Insurance quotes
7. Accident prone
8. Gap insurance
9. The odds are overwhelming OR overwhelming odds
10. Double indemnity
11. Excess lines
12. Adverse selection

By Kashyap Saraiya and Wayne Cotter

Brain Teasers were conceived by Kashyap Saraiya, CPCU, AIE and Wayne Cotter, CIE. Kashyap Saraiya is the Training Director for the New York Insurance Department. Wayne Cotter is the editor of this publication

Current Federal Disaster Legislation – 106th Congress

Bill	Name	Sponsors; Committee	Purpose/Description	Status
H.R. 21 1/99	The Homeowners Insurance Availability Act	Lazio (NY); 111 co-sponsors House Banking	To establish a Federal program to provide disaster reinsurance to private insurers, reinsurers, state insurance and reinsurance programs and other interested parties for residential property losses to homes and the contents of apartment buildings.	Amended bill reported out of banking 11-99; pending House action
S.1316 7/99	The Natural Disaster Protection and Insurance Act	Stevens (AK), 16 co-sponsors; Senate Commerce Committee	To amend the Earthquake Hazards Reduction Act of 1977 to provide for an expanded Federal program of hazard mitigation, relief, and insurance against the risk of catastrophic natural disasters to homes and the contents of apartment buildings, such as hurricanes, earthquakes, and volcanic eruptions, and for other purposes. Note: This is the Senate companion to HR 21.	Referred to Commerce; One hearing held.
H.R. 2749 8/99	The Policyholder Disaster Protection Act	Foley (FL) 72 co-sponsors; House Ways and Means Committee	To amend the Internal Revenue Code of 1986 to provide for the creation of disaster protection funds by property and casualty insurance companies for the payment of policyholders' claims arising from future catastrophic events.	Referred to Ways and Means
S.1914 11/99	The Policyholder Disaster Protection Act	Mack (FL); 1 co-sponsor; Senate Finance Committee	To amend the Internal Revenue Code of 1986 to provide for the creation of disaster protection funds by property and casualty insurance companies for the payment of policyholders' claims arising from future catastrophic events. Note: This is the Senate companion to H.R. 2749.	Referred to Senate Finance
H.R. 3303 11/99	The Natural Disaster Insurance Solvency Act	Burr (NC); no co-sponsors; House Banking, Ways and Means and Budget	To provide for the establishment of the Natural Disaster Insurance Solvency Fund to ensure adequate private insurance reserves in the event of catastrophic natural disasters.	Referred to Banking; Ways and Means; Budget
H.R. 481	The Earthquake, Volcanic Eruption, and Hurricane Hazards Insurance Act	Mink (HI); no co-sponsors; Banking, Science	To provide for a Federal program of insurance against the risk of catastrophic earthquakes, volcanic eruptions, and hurricanes, and for other purposes.	Referred to the Banking and Science
S.583 3/99	The Disaster Mitigation Act	Chafee (RI); no co-sponsors; Environment, Public Works	To amend the Robert T. Stafford Disaster Relief and Emergency Assistance Act to authorize programs for pre-disaster mitigation, to streamline the administration of disaster relief, to control the Federal costs of disaster assistance, and for other purposes.	Referred to Environment and Public Works
H.R. 2393 6/99	The Disaster Burden Relief Act	Baird (WA); no co-sponsors; Ways and Means	To amend the Internal Revenue Code of 1986 to provide disaster relief for homeowners.	Referred to Ways and Means
H.R. 2728 (8/99)	The Two Floods and You Are Out of the Taxpayers' Pocket Act	Bereuter (NE); 7 co-sponsors; Banking	To amend the National Flood Insurance Act of 1968 to reduce losses to properties for which repetitive flood insurance claim payments have been made.	Referred to Subcommittee on Housing, Community Opportunity

REGULATORY ROUNDUP

By

**Stroock & Stroock
& Lavan LLP**

COLORADO – Governor signs deregulation bill

On April 24, 2000, Governor Bill Owens signed into law Senate Bill 106, a deregulation bill intended to streamline the regulatory approval process. Senate Bill 106 eliminates prior approval requirements for credit insurance forms (including credit life insurance) and preneed funeral contract forms, citing the immediate need of the insurance market for these types of insurance. Sellers of credit insurance and preneed funeral contracts are required, however, to submit to the Insurance Commissioner a certification verifying the compliance of all forms with Colorado Law. Credit life and credit accident and health insurers are also required to file schedules of premium rates. Senate Bill 106 also eliminates certain filing requirements applicable to other lines of business. For example, medical malpractice insurers no longer need to submit the assignment and assessment of risk for different classifications for different specialties or practices of medicine. Similarly, HMOs and PPOs are no longer required to submit for approval deductibles, coinsurance options, conditions, and limitations. To view the bill, visit www.state.co.us.

MONTANA – Attorney rules of professional conduct limit insurer-imposed billing rules and procedures

On April 28, 2000, the Supreme Court of Montana ruled that an attorney may not (1) agree to abide by any insurer billing and practice rules which limit or direct the scope of representation of an insured, or (2) submit to an insurer's auditors billing or other detailed descriptions of professional services before obtaining informed client consent. On the first issue, the court concluded that the insurer's litigation management plan, which required the insurer's prior approval before a defense attorney was permitted to schedule

depositions, conduct research, employ experts, or prepare motions, violated state rules of professional conduct. The court reasoned that the insured is defense counsel's sole client and that an insurer's requirement of prior approval fundamentally interferes with defense counsel's exercise of independent judgment. On the second issue, the court found in conflict with state rules of professional conduct the insurer's reservation of the right to audit the books and records of defense counsel for compliance with its litigation management guidelines. The court equated the disclosure of such information with an unauthorized disclosure to a potential adversary. Such disclosure is permissible only where the insurer first obtains the informed consent of the insured. See *In re The Matter of Ugrin, Alexander, Zadick & Higgins, P.C.*, 98-612 (Mont. 4/28/2000), 2000 Mont. LEXIS 104.

NEW HAMPSHIRE – House rejects financial services privacy legislation that differs from the federal Financial Services Modernization Act

In April, the New Hampshire House of Representatives rejected House Bill 1623, a financial services privacy bill that generated controversy over provisions that would have exceeded those contained in S. 900, the federal Financial Services Modernization Act. S. 900, signed into law by President Clinton on November 12, 1999, requires financial institutions to grant customers the opportunity to opt-out of any disclosure of nonpublic personal information to a nonaffiliated third party. In contrast, New Hampshire Senate Bill 1623 included a more rigid opt-in requirement, permitting financial institutions to disclose customer financial information only after obtaining the affirmative consent of the customer. New Hampshire Senate Bill 1623 did, however, permit the disclosure of financial information among employees of affiliated financial institutions, provided that such disclosure was limited to information necessary to fulfill employee duties. To view U.S. Senate Bill 900, visit thomas.loc.gov. To view New Hampshire House Bill 1623, visit www.state.nh.us.

The New York-based Stroock & Stroock & Lavan LLP Insurance Regulatory/Corporate Practice Group includes Donald D. Gabay, Martin Minkowitz, William D. Latza, and Vincent Laurenzano, an insurance finance consultant. They gratefully acknowledge the assistance of Todd Zornik, a law clerk at Stroock.

NEW YORK – Assembly introduces financial services privacy legislation that differs from the federal Financial Services Modernization Act

On May 9, 2000, the New York State Assembly introduced AB 11031, a financial services privacy bill that would subject financial institutions to stricter privacy standards than those contained in S. 900. For example, AB 11031 would create an opt-in standard, prohibiting financial institutions from disclosing nonpublic personal information to a nonaffiliated third party without first obtaining a customer's written or electronic consent. The bill carves out certain exceptions to the general opt-in rule, including disclosures made to any person, such as an accountant, who is providing professional services to the financial institution. AB 11031 also prohibits financial institutions from disclosing an account number to a nonaffiliated third party for use in various marketing activities. The bill would create a private right of action in the event of any prohibited disclosure. AB 11031 is currently pending in the Assembly Codes Committee. To view the bill, visit www.assembly.state.ny.us.

NEW YORK – Anti-steering law may not be applied in a manner that restricts an insurer's First Amendment right to commercial free speech

On May 4, 2000, the U.S. District Court for the Southern District of New York granted the summary judgment motions of several plaintiff insurers, declaring New York Insurance Law Section 2610(b) unconstitutional as applied to the plaintiffs. Section 2610(b) prohibits an auto insurer, when processing a claim, from recommending a particular auto shop to conduct repairs, unless expressly requested by the insured. Based on this law, the New York Insurance Department threatened to fine one of the plaintiffs for communicating its selection of preferred repair shops by posting notices to this effect at certain drive-in facilities in New York. The New York Department took similar enforcement action against another plaintiff for offering premium discounts to insureds who requested, at the time of application, that the company recommend specific repair shops in the event of a covered loss. The court concluded that the plaintiffs' efforts to communicate information about preferred repair shops constituted commercial speech protected under the Free Speech Clause of the First Amendment of the United States Constitution. The court asserted that the threat of coercive steering

alleged by the Department was not supported by reliable evidence and that the Department's application of Section 2610(b) to the plaintiffs did not serve to prevent the alleged harms. See *Allstate Ins. Co. v. Serio*, 2000 U.S. Dist. LEXIS 6055.

Following the court's decision, the New York Department issued Circular Letter No. 16 (May 10, 2000), stating that insurers are "now free to recommend or suggest that repairs to a damaged vehicle be made in particular places or repair shops regardless of whether the insured expressly requested such recommendations." To view Circular Letter No. 16 (May 10, 2000), visit www.ins.state.ny.us.

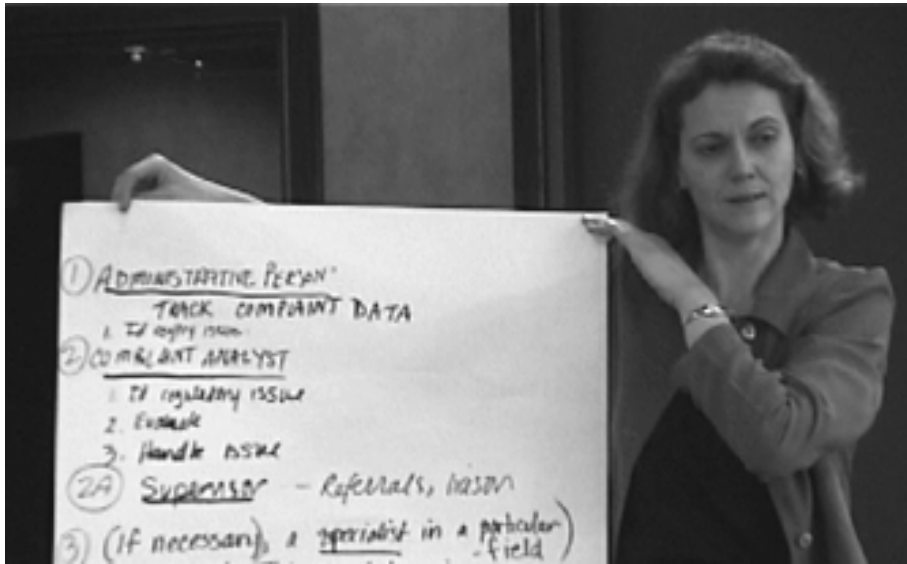
VIRGINIA – Governor signs deregulation bill

On April 19, 2000, Governor Jim Gilmore signed into law Senate Bill 587, a regulatory modernization bill that deregulates rates and forms for large commercial policyholders. Senate Bill 587 amends Section 38.2-317 of the Code of Virginia to exempt from prior filing requirements "large commercial risks", which is defined to include any person or entity that has a risk manager to negotiate insurance coverage and satisfies at least two additional criteria set forth in the bill, such as the possession of a net worth in excess of \$10 million, the generation of annual revenues in excess of \$25 million or the employment of more than 80 full-time employees per individual insured. The prior filing exemption does not apply, however, to workers' compensation, professional liability, or commercial automobile policies issued to large commercial risks. To view the bill, visit leg1.state.va.us.

IRES CDS: Next Up

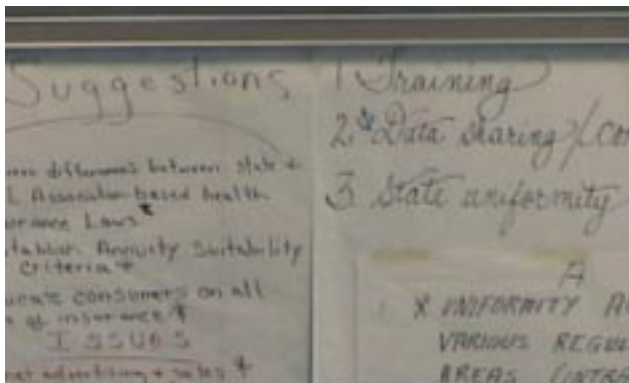
- 2000 — New Orleans. July 30-Aug. 1 Hyatt Regency
- 2001 — Baltimore. Aug. 5-7 Hyatt Regency Inner Harbor
- 2002 – San Antonio. July 28-30 Hyatt Regency

Regulators focus on teamwork at the 2000 IRES/NAIC school



About 40 regulators from across the United States went back to school in May to tackle the latest challenges facing state insurance regulators. They were gathered for the Year 2000 edition of "Regulating the Marketplace," a week-long school sponsored by the NAIC and the Insurance Regulatory Examiners Society.

The school brings together veteran regulators from all regulatory disciplines to tackle regulatory problems and solve mock insurance "crises." The goal is to demonstrate the importance of teamwork among regulators — both within insurance departments and across the country.



[Clockwise from top left] Alice Knapp of the Maine Bureau of Insurance is a human flip chart during a session on complaint handling. . .Regulators argue the best way to handle a troublesome insurer. . .Arkansas Commissioner Mike Pickens lectures about federal/state issues. . .Large notes on the walls keep the class focused on the issues. . .IRES President Angela Ford, leads an all-day session on coordinating market conduct exams.

Upcoming NAIC Education & Training Department Programs

FOR REGULATORS ONLY

Financial Examiners

August 7-10, Kansas City

Designed to give the beginning financial examiner and financial analyst an orientation to insurance regulation, this program provides an overview of P&C and life insurance, the annual statement, assets and liabilities, SAP and GAAP, reinsurance, examinations, and risk-based capital.

Commissioners Forum – July 17-19, Kansas City

The Commissioners Forum provides opportunities to learn strategies and techniques to enhance skills that improve the effectiveness of state regulation. This program is for commissioners and senior-level staff.

Financial Analysis Training – July 31-August 1, Kansas City

This program is designed to educate participants on financial analysis techniques utilizing NAIC solvency surveillance tools, including the Financial Analysis Handbook, FAST Scoring System, Company Profiles, and IRIS Ratios. It relates these tools to NAIC Accreditation Standards for financial analysis.

Automating the Examination Process – Sept. 18-20, Kansas City

Targeted to examiners and automated examination specialists responsible for incorporating computer-assisted audit techniques into the examination process, this workshop evaluates how to use computer systems more effectively in the examination process.

Surplus Lines – October 2-4, Kansas City

The program, for all levels of regulators, provides an overview of the surplus lines industry and its regulation.

Regulating for Solvency – October 23-26, Kansas City

Designed for financial regulators with at least four years experience, this program addresses current issues in monitoring insurer solvency and examines leading-edge regulatory methods.

Financial Regulation of Managed Care Organizations – November 13-15, Kansas City

This new program for regulators provides an overview of the financial regulation of managed care organizations.

FOR THE PUBLIC

Annual Statement Changes with a Codification Update July 10-12, Albuquerque, August 9-11, Baltimore

An update on recent Codification activity and interpretations of some of the Statements of Statutory Accounting Practices will be provided. This program benefits those responsible for the preparation, analysis, or auditing of annual statements.

Annual Statement Investment Schedules Seminar August 8, Baltimore

Beginning with the basics and moving on to more complicated issues, this seminar is beneficial to insurance company investment staff, as well as investment bankers/brokers who assist insurance companies. Instructors explain the function and reporting requirements of the different investment schedules contained in the annual statement and provide statutory accounting guidelines for preparing the schedules.



Health Annual Statement Preparation Workshop August 21-24, Boston – Basic

September 25-28, Atlanta – Basic

Targeted to those assisting in the preparation of statements or new to a statutory accounting/reporting environment, this workshop provides “how to” guidance on the preparation of the new health statement. Besides statement completion, topics include the regulation of health insurers, statutory accounting, and electronic filings.

Health Annual Statement Preparation Workshop June 26-29, Denver – Advanced

July 24-27, Kansas City – Advanced

November 28-December 1, Baltimore – Advanced

Targeted to experienced persons responsible for the preparation, analysis, or auditing of statements, this workshop provides guidance on the preparation of the new health statement and any accounting changes as a result of Codification.

P&C Annual Statement Preparation Workshop October 16-19, Charlotte

Targeted toward those responsible for the preparation, analysis, or auditing of property/casualty annual statements, this workshop provides hands-on opportunities and guidance on the preparation of the property/casualty annual statement and various supplements.

Life Annual Statement Preparation Workshop October 30-November 2, Dallas

Especially for those responsible for the preparation, analysis or auditing of life annual statements, this workshop covers the peculiarities of the life annual statement. Instructors provide hands-on opportunities and guidance on the preparation of the life annual statement and various supplements.

For more information, call the Education and Training Department at 816-783-8200. You may also find information on the Internet at www.naic.org, “Products & Services.”

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When disaster
strikes — see story
page 12



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- S. 900 update
- Privacy issues
- Uniformity in agent-broker licensing
- IRES Board of Directors elections
- Annual IRES Commissioners
Roundtable from New Orleans