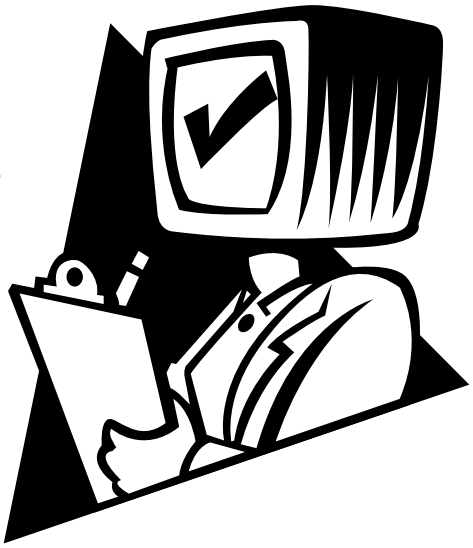
THE REGULATOR™
INSURANCE REGULATORY EXAMINERS SOCIETY

Rating the raters



What should consumers and regulators make of A.M. Best and other rating agencies?

by Scott Hoober
Special to *The Regulator*

One of the things that insurance regulators do for a living is to review the financial standing of insurance companies, examining publicly available material and, in many cases, going on-site to conduct their own audits.

The results of the on-site examinations are available to the public, in some states via the Web.

Meanwhile, large national companies do the same kind of thing, usually charging companies big bucks, and then charging consumers for their report. Do their ratings make any sense? Should consumers trust them? Should regulators rely on them? Or should regulators get into the business of issuing formal financial-stability ratings of their own and put A. M. Best and Standard & Poor's and Moody's and Weiss and Duff & Phelps out of business?

After all, those for-profit companies are looking at much of the same data as the state insurance departments and trying to come to the same conclusion: Is this company financially sound and likely to stick around for the long haul?

NAIC Takes a Look

OK, so perhaps insurance regulators shouldn't set themselves up in competition with rating agencies, any more than, say, banking regulators should compete with Moody's and S&P to rate banks' soundness.

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Identifying regulatory excellence

by Richard E. Stewart

The last people to decide whether a regulatory system should survive are the people who run it, and next-to-last are the people it regulates. Yet the question holds for them an enduring fascination, and their capacity to fret and chatter about it has no known limit.

The regulation of insurance is part of the larger culture of regulation. The universal preoccupation with survival is as marked here as elsewhere. The one variant is that in insurance there is thought to be a meaningful alternative – regulation at the national level of government – and so the question of survival comes up in the form of national versus state regulation.

It is more a question of mechanics than of goals. The question is

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From the President

Spread the Word

Current budgetary shortfalls facing state governments are the worst since World War II, according to the National Conference of State Legislatures' (NCSL) most recent survey. As a result, states are cutting programs and personnel at unprecedented rates, which means fewer resources for most state insurance departments and fewer regulators to protect the public.

Estimates of state budget gaps have ballooned by more than half in just a few short months. In a November NCSL survey, 36 states had projected a budget gap of $17.5 billion for the current Fiscal Year. That estimate has now swelled to $25.7 billion according to the most recent survey. The projection for Fiscal Year 2004 is even worse: a cumulative state shortfall of $68.5 billion.

These deficits, I believe, will greatly impact market conduct and consumer affairs regulation over the next year or two. Current resources devoted to these functions are now just barely sufficient to effectively regulate the industry. Back-door regulation, as required with many speed-to-market products, is likely to be tested to its limits under these new budgetary constraints. Even those states that opt to downsize through attrition are likely to lose their most experienced and savvy market regulators.

It is clear that states must continue to — now more than ever — educate and train insurance department personnel, and IRES remains the key educational source for training insurance department personnel. We all know times are tough, and

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President's Column ...

in such times it's always tempting to trim budgets for training and education. But that would be a mistake. State insurance regulators are facing speed-to-market initiatives; new products and technologies; and a host of difficult market issues that will surely test our mettle. I challenge states to find the resources to continue to support IRES and similar organizations so their insurance department staffs remain informed, educated and highly motivated.

I also challenge IRES members to step up; to get more involved in their organization; to reach out to fellow regulators in new and imaginative ways. Think about how you can participate in this year's IRES CDS with *or without* Department funding. If you're planning a vacation this summer, consider the great Southwest and plan your holiday around our CDS. Talk up our organization in the workplace. Let your commissioners know about the value of our annual educational seminar and enlighten them to the benefits of staff participation.

Remember, more than 20 new commissioners are now coming onboard throughout the U.S. and most will not understand the history, purpose or role of our organization. It's up to you to spread the word.

Paul J. Bicica

Paul J. Bicica, CIE
IRES President

Brad Connor retiring

One of the Society's founding fathers

W. Bradford Connor, CIE, of Missouri, is retiring from state insurance regulation March 31. Brad was one of the founding fathers of the Insurance Regulatory Examiners Society, a longtime member of its Board of Directors. He was president of IRES in 1989. In 1994, he was named recipient of the IRES President's Award in recognition of his many years of service to the organization.

Brad Connor

"Brad was the model for all other examiners to follow," said former New York regulator John Reiersen, who was a colleague of Connor's on the original IRES Board of Directors. "He led by example and his enthisiasm encouraged others to take his lead. He was the linchpin in the formation of IRES and in obtaining respect for the work of market conduct examiners.

"Brad could be annoying. Brad was persistent. Brad was not always right but he always advocated his position well. Most of all, Brad is a friend and he will be sorely missed."

Connor plans to get reacquainted with many of his relatives, do volunteer work and perhaps even return to teaching after leaving state service.

We salute Brad Connor for his decades of service to Missouri insurance consumers and for his longstanding dedication to IRES.

Welcome, New Members

Nancy A. Askerlund, UT
Frank R. Basnett, AIE, SC
Sally D. Bautista, HI
William G. Benson, AIE, VA
Daniel H. Cheung, HI
Christopher DiLorenzo, AIE, CT
Jim Dixon, HI
Mark J. Duffy, CIE, CT
Robert H. Forsyth, Jr., IL
Kimberlee A. Hewitt, CIE, MT
Rhonda Hotchkiss, NE
James J. Huber, AIE, KY
Kathryn A. Jones, VA
Delbert L. Knight, AIE, AZ
Mark S. Lippiatt, AR
Joseph R. May, MS
Charles J. Metcalf, IL
Trissa L. Nelson, LA
Timothy R. Nutt, AIE, independent
George Rabb, Jr., CIE, LA
Damiki M. Saunders, MD
Gary Stephenson, AIE, OR
Paul B. Wilkinson, VA
Christine Young, HI
Scott Zager, NE

Rating the insurance raters

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Yet the role played by the rating agencies — both with regard to insurers and, especially since Enron *et al.,* with respect to public companies — is under scrutiny by everyone from the Securities and Exchange Commission on down.

After all, the larger of the raters, known as NRSROs (nationally recognized statistical rating organizations), are recognized in numerous federal and state regulations. Yet they're totally unregulated.

In the case of Enron, the major raters kept listing them as financially sound up to four days before they filed for bankruptcy. Over the years, ratings of numerous other companies — including insurance companies — have been equally misleading.

In good times, the ratings seem to make sense, and we can all safely take them at face value, and urge consumers to do the same. But good times never last. It would seem like a good idea to take a closer look at the NRSROs.

That's exactly what the National Association of Insurance Commissioners has begun to do.

A new working group, chaired by New York, has just begun to reach out to the rating organizations, with an eye toward closer communication between regulators and raters. It's too soon to tell where the effort will lead. But it's not too soon to examine the way the raters rate, and to look at the level of wariness regulators should feel toward their output.

As Mississippi Insurance Commissioner George Dale put it, "They provide a service, yes, but we don't put all of our eggs in their basket. They're one of several things a consumer should use in evaluating a company.

"There's an immense amount of information that an insurance department has. There are consumer complaints, the examination information that they have," he said.

> **"They provide a service, yes, but we don't put all of our eggs in their basket. They're one of several things a consumer should use in evaluating a company."**
>
> **— George Dale**
> **Mississippi Insurance Commissioner**

Consumers should start there, Dale added. "and then use the rating organization along with that to determine what's the best company for them to choose. But not the rating organization by itself."

The good news is that the raters are at least trying to look at the right thing.

Consumers want to know one thing: Will this company be there when I have a claim, and will it have the cash on hand to cut me a check?

Yet even there the raters have varying orientations.

"We have insurance financial-strength ratings, or claims-paying-ability ratings, and they are used by distributors of insurance policies, and by the ultimate customers, the individuals who buy the policies," said Robert Riegel, managing director of Moody's Life & Health Insurance Team.

"But our slant is a little bit different than A.M. Best and S&P, which have much broader rating coverage," he added. "I think their ratings are used in the retail markets a little more extensively."

That's because Moody's primary focus is on the institutional marketplace.

"We have focused our ratings on companies that have debt securities outstanding, or insurance contracts that are very much debt-like. Our ratings are being used extensively by the purchasers of those debt securities or debt-like insurance contracts, and our ratings are intended to communicate the credit risk associated with the insurance company for the benefit of the purchaser of the security or the insurance contract," Riegel said.

"We really have not moved downmarket to retail insurance companies, to smaller companies."

L&H vs. P&C

Because of its orientation, Moody's pays virtually all of its attention to life insurers. That's fine for consumers concerned with whether their annuity will

actually be available for their retirement, or whether their life insurance policy will be there for the family when they die.

If you're concerned about your homeowners, auto or commercial policy, don't count on Moody's for advice.

"P&C companies have other issues — the whole reserve adequacy question, asbestos, environmental," said Riegel.

"They don't have the investment portfolio concerns that the life insurance companies have. Life insurance companies take credit risk. That's how they make money, more like a bank. You earn a spread between the yield on your investments and your net liability. If you have a lot of credit losses, the spread narrows and your profit margin diminishes, very much like a bank.

"P&C is totally different."

Moody's began analyzing insurers' financial health in 1986, S&P in '83 (though they've been rating bonds and other debt since 1909 and 1923 respectively). Duff & Phelps, founded in 1932, got into insurance rating in '86, and Weiss Research, which started out in 1971 in bank safety, jumped in in '89.

But when it comes to insurers, A.M. Best is the granddaddy, having been rating them since 1906. For years, it had a lock on the business, charging a nominal sum to come out and review a company, then marketing the results.

Rapping the raters

As expected, Robert Hunter, the outspoken insurance director for the Consumer Federation of America, is skeptical of all the raters — especially the mainline ones like Best.

"I think Weiss does a good job, because they're the toughest," he said. "I tell people, If you can get a top rating from Weiss, you're probably safe."

Hunter also raps the raters for what he calls "grade inflation." Not that companies' grades creep up from year to year, but that just about any company whose CEO isn't at that moment in the penitentiary can get a C. Now, a grade of C may be OK for an elective course in college, but not for an insurance company.

"Most people have a vision in their mind of what A, B and C mean," Hunter said. "B to me was always great if I got it in school. But I don't think I'd want to have a long-term-care program with somebody who's a B. I think it tends to confuse the average consumer."

Other critics say confusion is the least of it.

Since raters charge companies for the privilege of being rated, there's an obvious risk of conflict of interest.

The rating organizations say that in the current climate, they have no choice but to charge for their services. Yet other raters, both those evaluating equities and those checking up on creditworthiness (such as Egan-Jones and Mikuni) don't take cash from the companies they rate.

> **"Most people have a vision in their mind of what A, B and C mean. B to me was always great if I got it in school. But I don't think I'd want to have a long-term-care program with somebody who's a B."**
>
> **— Robert Hunter**

Other criticism:

- Like accounting firms, rating organizations often sell other, noncore advisory services. As it has with accountants, this can lead to conflicts.
- Raters are exempt from Regulation FD (the SEC regulation calling for simultaneous full disclosure to everyone of material information), ostensibly so they can gather nonpublic data and mix it in with publicly available data to come up with their ratings. But the exemption makes it hard for consumers or regulators to know which set of information was the more critical in upgrading or downgrading a company.
- Most of all, perhaps it's time to stop certifying raters through the NRSRO system. It gives a gloss of regulation to the rating process, but without any genuine regulation. Critics argue that it's time to either regulate the raters — or to open up the field to new, presumably more nimble competitors.

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Rating the rating agencies

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Pressure to perform

The current quasi-monopolistic system has a number of unintended side effects.

For instance, despite questions about the validity of the whole process — are raters looking at the right stats? are downgrades, and upgrades, given for the right reason? are ratings really predictive? — consumers, regulators, the press and the companies themselves pay a great deal of attention to ratings.

Some people seem to feel that the press is the feedback mechanism by which executives are pushed to change corporate policies.

Moody's Riegel, for one, thinks the press is no more intrusive or influential than before. "I've been here 15 years, and the publicity of ratings was widespread back in the early '90s, when Executive Life and Mutual Benefit failed. So I don't think it's anything new."

Hunter agrees that despite all the publicity, the pressure comes from within.

"It's a sort of intramural game that goes on inside the industry," says Hunter. "Everybody wants to be liked by their peers.

"And for some reason, when the cycle turns, we always have the rating agencies pressing for reserve increases when they may or may not be needed."

Hunter questions whether the raters' emphasis on shoring up reserves is really helping consumers or companies over the long term.

"You wonder on whose behalf they're doing this lobbying," he said. "Is it really for the consumer, or is it for the industry profitability over the next few months?

For now, though, Best and the other raters are the only outfits publishing ratings. There's certainly no groundswell of support for putting NAIC's Insurance Regulatory Information System (IRIS) ratios into a form that can be made public.

The semi-official ratings of the NRSROs are so visible, consumers are going to rely on them in any case. A number of state insurance departments go with the flow and assist in their dissemination — though the consensus is that, as Mississippi's Dale says, there are other things to look at as well.

The Illinois department, for instance, urges consumers to check with them to see whether and how long the company has been licensed. It also recommends checking out each company's complaint ratio. Then and only then does it suggest checking out the Best rating.

Reform

In a way, this seems to be an unusual time to be questioning the role that the raters play in the industry. The norm is for attention to come only after a particularly bad spate of failures.

Riegel defends his firm's role in helping predict and forestall failures, saying Moody's has been properly tough on life insurers.

"We saw a change in the credit profile of the life insurance industry last year," he said. "It's under more stress and pressure now. That's why we put a negative outlook on the industry and took the rating actions (downgrading about one in four of the companies it follows).

"The P&C industry is more market cycles. The life insurance industry is exposed to credit cycles. And when you have a bad economy like this, you have all-time high default rates of both investment-grade and non-investment-grade bonds, that's going to impact the investment portfolio of life companies.

"We saw it back in '90 and '91, we're seeing it again now, 11 to 12 years later."

Since Enron/WorldCom/Global Crossing, skepticism has spread from equities and credit to insurance. Interestingly, the criticisms, and the reform proposals, seem to make sense across the board. Meantime, William Donaldson President Bush's nominee as new head of the SEC, said during

Rating the rating agencies

his confirmation hearing that the agency should "take a hard look" at opening up the rating agencies to additional competition.

The SEC has recently published a "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Market." Its criticisms, and its conclusions as well, seem just as valid with respect to insurance ratings.

> **"Because the credit rating agencies are subject to little, if any, formal regulation or oversight . . . little exists to hold them accountable for future poor performance."**
>
> **— SEC report**

For instance, the report cites an earlier staff report that argues, "because credit rating agencies are subject to little, if any, formal regulation or oversight, and their liability traditionally has been limited by regulatory exemptions and First Amendment protections afforded them by the courts, little exists to hold them accountable for future poor performance." (Note: Full report available at www.sec.gov/news/studies/credratingreport0103.pdf).

And in noting that the raters' role has been enshrined in numerous state and federal statutes and regulations (including at least a few states' insurance regulations), the SEC notes that some have argued that "some form of regulatory approval of rating agencies is appropriate to the extent credit ratings are used in regulation."

In one of its strongest statements, the SEC report says that "in the case of Enron, the credit rating agencies failed to use their legally sanctioned power and access to the public's benefit . . . .did not ask sufficiently probing questions . . . and in many cases merely accepted at face value what they were told. . . Further, the rating agencies apparently ignored or glossed over warning signs, and despite their mission to make long-term credit assessments, failed to sufficiently consider factors affecting the long-term health. . . . [And] little exists to hold them accountable for future poor performance."

Sure, they're talking about Enron. It's legitimate to ask, however, what's to prevent the same harsh accusations in the near future following the failure of an insurance company? ■

Quote of the Month

"The magnitude of next year's budget gap is startling. Thirty-three states estimate budget gaps in excess of 5%, with 18 of those facing gaps above 10%. There is great cause for concern since the deficit numbers continue to grow at an alarming rate."

— Angela Monson, president of the National Conference of State Legislatures, commenting on a January 2003 NCSL survey of state budget deficits.

STEWART: Identifying regulatory excellence

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whether the states or the national government, or some combination of the two, can better do what the public has a right to expect from a regulatory system.

First, we should ask if we can recognize a good regulatory system or a good regulatory agency when we see one. It is not a fatuous question.

So what are the distinguishing qualities of a good regulatory agency.

Granted that any public agency must begin with an honorable devotion to the public interest, we might list the main, specific qualities of a good regulatory agency as competence, independence, power and vitality. These four qualities are not exhaustive; they overlap, interact and reinforce each other; they may not even make up the best list of their kind; and it is certainly a current, not a permanent list. But these four qualities do have one very useful thing in common.

First, we should ask if we can recognize a good regulatory agency when we see one. It is not a fatuous question.

They are qualities of the agency itself, and not of the agency's work. They are qualities of the agency and, as such, are matters which the public and its government can do something about.

Richard E. Stewart served as Superintendent of the New York Insurance Department from January 1967 to December 1970. This article, printed with Mr. Stewart's permission, was excerpted from an address before the Annual Meeting of the American Life Convention in Washington, D.C. on **October 21, 1970**. Mr. Stewart is currently Chairman of Stewart Economics, Inc., a consulting firm specializing in insurance and insurance regulation.

Competence

The competence of an organization is more than the sum of the developed competence of individuals. It depends on how well the organization puts their efforts together and on how well it offers them ways, as individuals, to use their abilities to the utmost in work they believe to be worthwhile. How often, in government and elsewhere, this quality – the creative use of able people – seems to elude, or to be ignored by, the very large organization!

Independence

The second of the four qualities is independence. What is independence?

First, we think of independence from the regulated industry – meaning, not the absence of contact, but an independence of view and a freedom from undue industry influence on agency policy and decisions. Independence in that sense is subtle and, except for outlawing the more theatrical forms of misconduct, impossible to legislate or to order.

The real independence of the regulator from the regulated is not the absence or rejection of something. It is the stronger presence of something else – of a separate sense of purpose, of a concept of the public interest shared by the people in the agency and seen by them as their goal.

The agency's sense of having a value and purpose of its own, not derived from either boosting or harassing the regulated industry, can be developed. But it takes a deliberate effort, one more likely to be successful in a small agency than in a large one, in a new agency than in an old one.

Independence as a quality of a good regulatory agency, means more than independence from the regulated industry. It means political independence – the ability, and the will, to do the regulatory job without favoritism and without pandering.

STEWART: Identifying regulatory excellence

Different kinds of politics are apt to be involved in different jurisdictions and in different kinds of regulatory activity. Political pressure for favoritism is most likely to be brought to bear in the disposition of individual cases – where the agency is giving or taking away something of value to a particular businessman who is someone else's constituent or patron. Resistance to that kind of political pressure turns on the agency's own political strength and on the morale and character of its personnel.

While any good public agency must be sensible to the public consequences of its acts and responsive to the public it serves, the good regulatory agency also needs a balancing political independence that enables it to resist doing something that is popular but unsound, that merely takes the heat off, or that is desirable in the short run but more than commensurately undesirable in the long run. Good regulation is not a device by which government sacrifices the future to the present or by which it sabotages the consuming public, or the providing industry, by indulging the fads or passions of either.

> **Good regulation is not a device by which government sacrifices the future to the present.**

Power

The third quality of a good regulatory agency is power – the legal authority to do the job as set forth by the law and reasonable public expectations.

If that principle seems obvious, it is instructive to reflect on how poorly, at all levels of government and in many fields, the principal has been carried out.

Over and over again we have created agencies with what we thought was a clear public mandate, and later we have seen those agencies drift into a bickering senility. Why?

Sometimes the mandate itself was not a directive but a dream, not a setting of priorities but an abdication from choosing among laudatory and mutually conflicting objectives. Sometimes the purported mandate was a sham, and when the agency was later exposed for failing the public, it was being measured against a mission which its creators never intended for it.

Much of what passes for regulation is really a government mechanism for protecting the industry from itself and from intruders, for retarding change and for stabilizing demand, costs and profits. Insurance regulation, while not without those features, is far from the most striking example of them.

But even where the public mandate is real, the agencies often fail to get results. Are their members just more timorous and servile than the rest of mankind?

More likely it is that while we give an agency draconian sanctions which, if ever exercised, would be cruel and self-defeating, and while we give an agency the power to admonish and enjoin others to do what they should be doing anyhow, we fail to give the agency sanctions in between.

More likely it is that while we tell the agencies to act forcefully, we hobble them with procedures borrowed unthinkingly from the courts. While procedural and judicial checks upon administrative regularity and fairness are important, we must not think we get them for nothing.

Often the price in agency effectiveness is very high, particularly as those checks are elaborated beyond their original purpose of assuring due process and into an imitative judicialization of regulatory procedure and a judicial repetition, rather than review, of regulatory acts. In any regulated industry with any firms far larger and wealthier than the regulatory agency, the result is to make strong and even-handed

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application of the public mandate a prolonged, uncertain, wearing and disagreeable exercise.

In the giving of regulatory power commensurate with the regulatory mandate, the record of the states and the national government is uneven and frequently bad. There is not much ground for choosing either one over the other.

Vitality

The final quality of a good regulatory agency is vitality. Vitality comes with the sense of purpose which keeps an agency truly independent. Vitality of the agency is largely made up of the vitality of its people, of their interest in what they are doing and their sense of its worth. Such vitality comes from seeking talent, rewarding talent, and giving it the chance to engage, to stretch and to get excited.

At least in giving good people a chance to develop rapidly and to gain responsibility and prominence as soon as they are ready, a good smaller agency should be better than a good large agency, and many good smaller agencies would be best of all.

The agency's vitality is also something besides the aggregate vitality of its people. It comes from using the resources of the agency on things that matter, and avoiding the deadening preoccupation with familiar things that matter little or no longer.

The vital agency is constantly looking critically at what it does and at what it does not do. The vital agency is capable of change as circumstances change. It regards self-renewal as a normal and continuing process, as an object of pride and not embarrassment. As circumstances and problems change, the vital agency is alert to take on new functions and equally alert to change present rules and cast off present functions when they no longer serve a public purpose.

This kind of vitality depends on the leadership of the agency. It is the only one of the qualities of a good regulatory agency, or of any good organization, which has to come from the very top.■

Casual Observations

A Fine Mess

Now that several Wall Street securities firms have agreed to pay $1.4 billion to federal and state regulators to halt their investigations into stock analysts, these same firms are looking to their insurers to pay their fines. One public officer, who was not pleased by the turn of events, said, "As a matter of policy, we do not believe fines should be recoverable."

Wall Street countered by suggesting that if the term "fines" were changed to, say, "settlement payments" or "retrospective relief," perhaps insurers would ante up. Don't bet on it. Covering the financial consequences of one's illegal acts has long been contrary to public policy, no matter what name you call the disciplinary action.

Meet COLI's cousin

As a regular reader of *The Regulator,* you are probably familiar with COLIs (Corporate-owned life insurance), but how many of you have heard of CHOLIs? CHOLIs, or Charity-owned life insurance, have been around for years, but recently received attention as a result of an article featured in *The Wall Street Journal* (2/6/03).

With CHOLIS, charities seek out "contributors" who agree to be covered by life insurance policies that name the charity as beneficiary. Charities own the policies and typically fund premium payments through loans from the issuing life insurer. As an inducement to participate, contributors are offered small individual life policies free of charge. One problem that has emerged: contributors aren't dying as fast as charities had anticipated and those loan costs are adding up.

How international accounting standards will afffect the U.S. insurance industry

by Nick Mallouf

In December 1999, the predecessor to the International Accounting Standards Board (IASB), based in London, published an Issues Paper that sent a shot across the bow of insurance accounting departments around the world. The Paper's goal was to build a worldwide accounting and reporting structure consistent with the world insurance community and one that would allow for easier comparison of results by investors and policyholders.

Daimler Chrysler could be the poster boy for such international standards. In 2001, the company reported a net *income* of $733 million using German accounting standards. Under U.S. Generally Accepted Accounting Principles (GAAP), that became a *loss* of $589 million. Variances like this — and worse in less developed countries — prompted the Group of Seven industrialized nations to recommend the adoption of International Accounting Standards (IAS).

This article will review IASB's basic proposal and the insurance industry's response.

Opening Shot

The Issues Paper applies to all lines of insurance – L & H, P & C, and Reinsurance – and to products of all durations. While International Accounting Standards 39 (IAS 39) (Financial Instruments: Recognition and Measurement) and IAS 32 (Financial Instruments: Disclosure and Presentation) address the treatment of most insurance assets and some liabilities, *they specifically omit references to insurance contracts.*

Among other technical requirements, the IASB calls for a consistent but materially different accounting for insurance contracts – a "fair value" approach that treats insurance contracts like marketable securities – as if they could be bought and sold.

While this concept may hold true in certain countries, it clearly departs from U.S. insurance practice. It conflicts with GAAP and statutory requirements that permit different accounting/valuation for different types of products.

The IASB also introduces the concept of the impact of the insurance entity's own credit rating on the contract valuation and the potential impact of future market changes – something that could change between the effective date of the financial statement and the date that statement is published.

Key proposed changes include:*

1. Insurance Contracts
   a. Contracts with major investment features would be classified as either insurance or investment contracts.
   b. Under certain circumstances, some investment contracts can later be reclassified as insurance contracts.
2. Basic Measurement of Policy Values
   A single method of measuring policy values would apply to all insurance contracts – short/long term, life, annuity, health, property/casualty.
3. Fair Value
   a. Companies would be required to measure all assets and liabilities at fair value, i.e., the amount the insurer would pay a third party to assume the liability in an arm's-length transaction – this includes insurance contracts.
   b. Companies would be required to make future assumptions about economic events and market estimates, instead of using current noneconomic assumptions (mortality, expenses, etc.).
   c. Companies would be required to account for their own credit risk (although no guidance is provided regarding how to do this).
4. Valuing Policy Options/Guarantees
   Companies would be required to assign values to such items as minimum interest rate guarantees and guaranteed death benefits on variable products.
5. Financial Statement Disclosures
   Companies would be required to disclose expected earnings based on:

continued on next page

* Per Ernst & Young Survey

The impact on U.S. accounting . . .

continued from preceding page

- Prior period valuation assumptions
- Earnings of new business written
  - — contracts sold to new customers
  - — contracts sold to existing customers
- Release of margins
- Deviations between actual and expected experience by source
- Changes in assumptions

The European Commission mandated in June 2002 that companies listed on European Union stock exchanges must begin using IASB standards by January 1, 2005. This is anticipated to result in huge outlays for systems changes, accounting staff time and personnel costs. However, the standards relating to insurance contracts (that will be incorporated in IAS 39) are not likely to be implemented until 2007 or 2008, thereby making IAS 39 the standard for some European "financial instruments," but not for others.

Most of the U.S. (and many foreign) insurance industry, regulatory, and public accounting responses were very critical of the new methodology and reporting requirements.

An Ernst & Young survey of insurance executive concerns about the proposed standards found these three topping the list:

1. Volatility of financial results – under the new standards, all companies would have to report all assets and liabilities at "fair value." Thus, earnings would fluctuate based on interest-rate changes.
2. Impact on profits – insurers would have to record a profit or loss at time of sale of an insurance contract rather than at a future date.
3. The onerous disclosure requirements contained in the proposal.

The American Council of Life Insurers, the Life Insurance Association of Japan and the German Insurance Association all have urged the IASB to move slowly on its "fair value" requirement. The requirement compels companies to reassess the market value of in-force business every year.

The proposed fair value and economic impact requirements also complicate other key valuation and accounting issues– pricing, cash flows, reinsurance, discount rates and valuation of risk.

There is also a semantics war going on. The IASB considers its standards to be "principle based" while GAAP is perceived as more "rules based." But, as an article in Fortune magazine pointed out, international accounting standards have historically relied on the accounting firms and the companies themselves to faithfully represent accounting transactions. As a result, the standards leave significant leeway for aggressive corporate accounting and creative auditors.

Being rules based, GAAP theoretically leaves less room for judgment. (This, however, has not stopped U.S. firms and their auditors from "gaming" the system to manage earnings.)

However, as a result of the recently completed Norwalk Agreement, the Financial Accounting Standards Board (FASB) is working closely with the IASB to coordinate and "harmonize" the accounting standards for global application.

Ongoing Conflict

After reviewing the comments to its Issues Paper, the IASB Steering Committee started publishing chapters of the Draft Statement of Principles– Insurance Contracts in 2001. It is still a work in progress. At press time, 11 of its 14 chapters had been published.

The Draft Statement of Principles (DSOP) also calls for special financial statement reporting of the following:

Balance Sheet

- Present value of expected premiums
- Present value of expected claims
- Present value of expected nonclaim payments to policyholders
- Present value of expected expenses under existing contracts
- Reinsurer's share of each of the above
- Amount of provision for risk and uncertainty in policy liabilities
- Policyholders' interest in unallocated divisible surplus

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. . . of international accounting standards

continued from preceding page

Income Statement

- New business: change in value of contracts split between existing and new policyholders
- Existing business: change in value of in-force contracts
- Unwind of discount rate
- Release of provisions for risk and uncertainty
- Differences between actual experience and expected assumptions: separately for economic and noneconomic assumptions
- Effect of changes in assumptions: separately for economic and noneconomic assumptions

As each of the DSOP chapters emerges, industry has responded. Northwestern Mutual Life Associate Controller, Allan Close, responding on behalf of the American Council of Life Insurers, noted that IASB appears to be moving away from the "fair value" concept for insurance contracts to the "entity value" concept that is much closer to current U.S. practice.

Close also noted that another key problem for both industry and regulators is that, at the end of the day, somebody has to be able to audit the numbers. That means companies must have new systems in place to create the numbers – not just actuarial models. And for any company not already on this model of contract valuation, the financial and time commitment to develop the appropriate systems will be huge. Companies will not even be able to perform a reconciliation from U.S. GAAP to IASB standards without major accounting and actuarial system changes.

Regulators' Concerns

If the IASB succeeds in implementing its slate of accounting reforms, and the Financial Accounting Standards Board "harmonizes" GAAP to meet IASB standards, the result will likely be more volatility in financial statements. These changes will make it harder for companies to manage earnings. The new rules will affect any transition from statutory accounting to GAAP accounting (the so-called STAT-to-GAAP conversion). And the new volatility will make it harder for regulators to make period-to-period comparisons, develop performance ratios, and interpret early-warning signs of corporate financial failure or misdeeds.

Mel Anderson, chair of the NAIC Working Group on international accounting, noted that besides making it harder for insurers to "prove" earnings (the "Fair Value" concept), the new accounting standards will force regulators to deal with the effects on Market Values, IRIS Ratios, and the Smart Test.

This will require regulators to develop new models, assumptions, and measures to assess changes. "The NAIC can't wait for harmonization," said Anderson, "we have to monitor and provide input to the process so we're not playing catch up."

Anderson recommended that regulators:

- Monitor and provide input to the NAIC working group
- Monitor the IASB web site (see below)
- Sign up for the monthly report from the NAIC staff in the working group

At the NAIC quarterly meeting in New Orleans, the working group adopted a comment letter on the IASB proposed standards. The objective was to provide information that could be used to update the IASB's 11 published DSOPs by eliminating inconsistencies, conflicts, and redundancies between current accounting and the IASB standards. ■

For further information, you may contact: the International Accounting Standards Board (www.iasb.org.uk), Ernst & Young (www.ey.com), Alan Close, Assoc. Controller, Northwestern Mutual Life NAIC International Accounting Standards Working Group (alanclose@northwesternmutual.com)

Colossus will bite auto insurers if they're not careful

by Brian P. Sullivan

We have written this before, but apparently it bears repeating. What is legal isn't always smart. What is good for winning individual battles isn't always good for winning wars.

Exhibit A was the January 2, 2003 article in *The Wall Street Journal* regarding Allstate and its use of the Colossus system of assessing injury claims. The article lacks a nuanced understanding of insurance underwriting, attributing far too much influence to Colossus for Allstate's underwriting success. But the story reflects a broad concern about new tools for refining underwriting and claims, and insurers must be aware that trouble is brewing.

> **If indeed Allstate tweaked its Colossus database to generate low-ball proposed settlements, there is nothing inherently wrong in doing so.**

The big beef in the story is not that Allstate is using Colossus to analyze claims, though we know that many consumers and regulators dislike the concept.

Rather, the story attacks the ways in which Allstate allegedly adjusted the data to ensure that it would suggest lower claim payments.

Putting aside for a moment the merits of the complaints against Allstate, allow us an observation. If an insurer is going to use a database to systematically assess claims, it is critically important that the protocols be absolutely spotless when exposed to the light of day.

It doesn't matter if it is legal, and it doesn't matter if a database is considered only one part of the process. If the protocols aren't 100% above reproach by the general public (or a skilled newspaper reporter at the *Wall Street Journa*l), then trouble is brewing.

Lawyers in Love

Lawyers love databases. If dozens of claims reps independently decide that a certain type of injury is worth between $25,000 and $35,000, it is virtually impossible to attack that system. But if there is a piece of paper describing a claim and stating an expected value, or if there is a database that looks at claims and suggests a settlement, then the lawyers have a behavior to attack.

For a lawyer, the best part of a database of organized behavior is that any failure can be spun across tens of thousands of claimants rather than just a handful. Even minor discrepancies can turn into millions of dollars when applied over many cases over several years.

If indeed Allstate tweaked its Colossus database to generate low-ball proposed settlements, there is nothing inherently wrong in doing so.

After all, claim settlement is a process of negotiation, not rules-based payments. No injury is the same, no injured person suffers the same loss. Therefore, insurers and claimants are juggling competing desires.

Assume that both parties start off behaving in good faith, seeking a fair settlement for both. What happens when the first conversation finds a difference of opinion (as is almost always the case)? Then the horse trading begins. The insurer looks at what their risks might be if the case goes to court. A foolishly low offer that will send the case to court could ultimately wind up costing a fortune. The offer has to be high enough to avoid that risk.

Costs & Risks

Even when the insurer has what it considers a very solid case, there are costs associated with litigation that are better avoided. But on the claimant side, there are also risks. It is possible that a judge or jury will reward less than the insurer's

continued on next page

Colossus will bite

settlement offer, or nothing at all. And there are substantial costs, and long delays before payment. The claimant will almost certainly settle for less than they think they could ultimately get from the insurer in return for a certain payment, a quick payment, and the avoidance of legal costs.

A Colossus database does not set the settlement amount, but rather provides the framework for the insurer's first offer. If the database is set to provide offers far below the actual value of the claim, then the insurer will get thumped in court, and ultimately lose money. The claimant's attorney, if they are worth their 1/3 contingency fee, will recognize an unreasonably low offer.

This jousting may sound unpleasant, but it is the nature of such claims, particularly with third-party claimants who are not customers of the insurer, and particularly when dealing with soft tissue injuries resulting from low speed accidents.

While this makes perfect sense to those who are close to the claims process, to the public it looks horrible. Though many consumers are more than happy to pad their claims, they don't want insurers to lowball them in negotiations. That one-sided deal might not seem fair to insurers, but that's the way it is. Life isn't fair.

Staying Above Board

Getting back to Colossus, it is clearly a powerful and useful tool, and clearly provides a vital piece of information. But insurers must be above board in using such systems, and train adjusters to use them wisely and judiciously. If they want to be tough on settlements, they should do so within the parameters of all of the data, and be careful to allow the adjuster the power to make decisions. Otherwise they might find themselves on the front page of another newspaper. ■

Brian Sullivan is editor of *Auto Insurance Report,* a weekly newsletter in which this article first appeared.

C.E. News

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Members are encouraged to take a few minutes and think about the regulators that you know are qualified and deserving of this award and complete that nomination form. If you have any questions, please call Scott Laird, AIE, AIRC, CFE (Fraud) at 281-875-8363 ext. 2206.

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REGULATORY ROUNDUP

by
Stroock & Stroock
& Lavan LLP

WASHINGTON – Insurance Commissioner releases report on credit scoring

Washington Insurance Commissioner Mike Kreidler has submitted a report to the Washington State Legislature entitled "The Effect of Credit Scoring on Auto Insurance Underwriting and Pricing." The report was prepared pursuant to the mandate of Washington House Bill 2544, enacted last year, which restricted the use of credit scoring in several ways. For example, it prohibited the use of credit history as the principal basis for denying insurance coverage and prohibited the cancellation or non-renewal of an insurance policy solely based on credit history. The purpose of the report was not to confirm any correlation between low credit scores and higher loss ratios or to assess the overall fairness of credit scoring to individuals. Rather, the report was designed to determine whether credit scoring has an unequal impact on certain demographic groups, particularly with respect to ethnicity and income characteristics. The data upon which the report is based were drawn from records of several thousand randomly chosen policyholders insured by three insurers. The report identified several over-arching demographic patterns. For example, the report concludes that age is the most significant demographic factor and that older drivers, on average, have higher credit scores and lower credit-based rate assignments. Older drivers were also less likely than other drivers to lack a credit score. Moreover, people in lower income brackets frequently had lower credit scores and higher premiums. Data regarding ethnicity was less conclusive, although the report did find ethnicity to be a significant factor in some cases. *To view the report, visit www.insurance.wa.gov/publications/news/Final_SESRC_Report.pdf.*

INDIANA – House of Representatives unveils credit scoring legislation

On January 8, the Indiana House of Representatives introduced House Bill 1213, which would impose new requirements governing an insurer's use of credit information in the underwriting of personal property and casualty insurance. Commercial insurance is excluded. The Bill would prohibit various uses of credit information in the underwriting or rating of risks. Under the bill, an insurer would be prohibited from denying, canceling or declining to renew a personal insurance policy solely on the basis of credit information. The legislation would also prohibit an insurer from taking an adverse action solely because the consumer lacks a credit card account. The Bill would additionally require an insurer using credit information in the underwriting process to disclose that the insurer may obtain credit information in connection with the application and would also require that a consumer be sent notice if an adverse action is taken based on credit information. Such notice would be required to clearly state the reason for the adverse action. Violation of the new credit information use provisions would constitute an insurance unfair trade practice in Indiana. House Bill 1213 closely resembles the National Conference of Insurance Legislators (NCOIL) "Model Act Regarding Use of Credit Information in Personal Insurance," but does deviate in several instances from the NCOIL Model. *To view House Bill 1213, visit www.in.gov/serv/lsa_billinfo.*

NEW YORK – Senate introduces legislation that would establish the class E felony of unlawful procurement of clients, patients and customers

On January 14, the New York State Senate introduced Senate Bill 555 , which would make the use of "runners" illegal in New York. Senate Bill 555 defines "runner" to mean any person who for pecuniary benefit procures or attempts to procure a client, patient or customer for a provider, where it is clear that the provider intends to attempt falsely or fraudulently to obtain benefits under a contract of insurance or falsely or fraudulently to assert a claim against an insured or an insurance carrier for providing services to the client, patient or customer. "Provider" refers to any attorney, health care professional, owner or operator of a health care practice or facility, or any person presenting himself as such. A person would be guilty of unlawful procurement of clients, patients or customers, a class E felony, if he or she acts as a runner or solicits or otherwise directs another person to act as a runner. The Bill is modeled

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The New York-based Stroock & Stroock & Lavan LLP Insurance Practice Group includes Donald D. Gabay, Martin Minkowitz, William D. Latza, John R. Cashin and Vincent L. Laurenzano, an insurance finance consultant. They gratefully acknowledge the assistance of Todd Zornik, an associate in the group. This column is intended for informational purposes only and does not constitute legal advice.

after similar legislation enacted in New Jersey in 1999. According to the Memorandum in Support of Senate Bill 555, the use of runners is a common practice in the New York metropolitan area that has inflated New York insurance costs. The Bill was introduced as part of a New York State Senate plan to reform the state's no-fault automobile insurance system and to reduce fraud. *To view Senate Bill 555, visit public.leginfo.state.ny.us/menuf.cgi.*

NEW YORK – Senate submits automobile insurance anti-fraud legislation

The New York State Senate introduced Senate Bill 683 on January 17 to implement various measures intended to combat no-fault automobile insurance fraud. According to the Memorandum in Support of Senate Bill 683, courts have interpreted New York Insurance Law (NYIL) Section 5106 to preclude an insurer from asserting a fraud defense after the expiration of 30 days following receipt of a proof of loss. This 30-day period is often an inadequate time frame in which to conduct investigations necessary to determine whether a claim is fraudulent. The Bill would amend NYIL Section 5106 to allow an insurer to assert a defense to the payment of first party benefits after the expiration of the 30-day period. Senate Bill 683 would further direct the New York Superintendent to promulgate regulations detailing standards and procedures for the investigation and suspension or removal of a health service provider's authorization to receive payments for the types of medical services described in NYIL Section 5102(a). The Commissioner of Health and the Commissioner of Education, similarly, would be required to provide a list of all health services providers who have lost the authority to receive payment for medical services performed relative to any claim under NYIL Article 51. Senate Bill 683 also amends the New York Penal Law with respect to insurance fraud offenses and the New York Executive Law with respect to the use of funds of the Motor Vehicle Theft and Insurance Fraud Prevention Fund. *To view Senate Bill 683, visit public.leginfo.state.ny.us/menuf.cgi.*

CONNECTICUT – House of Representatives seeks to minimize the vicarious liability of automobile leasing and rental companies

The Connecticut House of Representatives on February 6 introduced House Bill 6421, which would repeal Section 14-154a of the Connecticut General Statutes. Section 14-154a imposes vicarious liability on automobile leasing and rental companies in connection with any damage to any person or property caused by the operator of a rented or leased car. Such leasing and rental companies are currently held liable to the same extent as the operator would have been if he had also been the owner. Proponents of the Bill argue that the Section 14-154a vicarious liability provision is yielding large judgments against automobile leasing and rental companies for damages caused by their lessees and renters. Such damage awards, in turn, have led to increased insurance premiums for automobile leasing and rental companies. Opponents argue that the Section 14-154a vicarious liability provision is necessary to protect accident victims when the operators' insurance coverage is insufficient to cover the damages. According to news reports, Connecticut is one of only three states (in addition to New York and Rhode Island) that hold leasing companies liable for unlimited damages when a leased vehicle is involved in an accident. Legislation similar to House Bill 6421 is also pending in New York. New York Assembly Bill 1042 would, among other provisions, deem the lessee of any leased vehicle under a lease of one year or more to be the owner for the purpose of determining liability in connection with the use or operation of the vehicle. *To view Connecticut House Bill 6421, visit www.cga.state.ct.us.*

Congress introduces legislation increasing disclosure requirements affecting company-owned life insurance

The U.S. House of Representatives recently introduced H.R. 4551, the federal Life Insurance Employee Notification Act, which would require employers to provide notification to any employees whose lives are insured under employer-owned life insurance. (Editor's Note: See July '02 Regulator for more information on employer-owned life insurance.) For employer-owned life insurance purchased on or after the date of the enactment of H.R. 4551, the notice would need to be provided within 30 days of the employer's purchase of the insurance. The notice would need to be in writing and include: (i) a statement that the employer carries such insurance on the life of the employee; (ii) the identity of the insurance carrier; (iii) the benefit amount of the policy; and (iv) the name of the policy's beneficiary. For former employees whose lives are insured under any employer-owned life insurance policy from January 1, 1985 through the date of the enactment of H.R. 4551, the employer would have to provide the notice within one year after the enactment of the legislation. For existing employees whose lives are insured by such an insurance policy as of the date of enactment, the employer would have to provide the notice within 90 days of enactment. Any violation of the provisions of H.R. 4551 would constitute an unfair method of competition and an unfair or deceptive act or practice under section 5(a)(1) of the Federal Trade Commission Act. *To view H.R. 4551, visit thomas.loc.gov.*

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