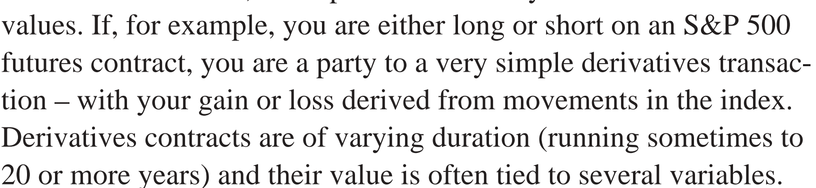
INSURANCE REGULATORY EXAMINERS SOCIETY

Derivatives as time bombs?

by Warren E. Buffet

Charlie* and I are of one mind about derivatives and the trading activities that go with them: We view them as time bombs, both for the parties that deal in them and the economic system.

Having delivered that thought, which I'll get back to, let me retreat to explaining derivatives, though the explanation must be general because the word covers an extraordinarily wide range of financial contracts. Essentially, these instruments call for money to change hands at some future date, with the amount to be determined by one or more reference items, such as interest rates, stock prices or currency values. If, for example, you are either long or short on an S&P 500 futures contract, you are a party to a very simple derivatives transaction – with your gain or loss derived from movements in the index. Derivatives contracts are of varying duration (running sometimes to 20 or more years) and their value is often tied to several variables.



Unless derivatives contracts are collateralized or guaranteed, their ultimate value also depends on the creditworthiness of the counterparties to them. In the meantime, though, before a contract is settled, the counterparties record profits and losses – often huge in amount – in their current earnings statements without so much as a penny changing hands.

The range of derivatives contracts is limited only by the imagination of man (or sometimes, so it seems, madmen). At Enron, for example, newsprint and broadband derivatives, due to be settled many years in the future, were put on the books. Or say you want to write a contract speculating on the number of twins to be born in Nebraska in 2020. No problem – at a price, you will easily find an obliging counterparty.

When we purchased Gen Re, it came with General Re Securities, a derivatives dealer that Charlie and I didn't want, judging it to be dangerous. We failed in our attempts to sell the operation, however, and are now terminating it.

But closing down a derivatives business is easier said than done.

*Editor's Note: Charles T. Munger, Vice Chairman of Berkshire Hathaway

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IRES to launch market conduct training project

A much-need "certification" program for market conduct examiners is the goal of a regulator training project being undertaken by the Insurance Regulatory Examiners Society.

The project is still in its early research and design stage. However, when completed, the Society hopes to be able to offer to regulators and state insurance departments a valuable training program to help ensure the proper training of those working in market conduct examination and compliance.

"Feedback from IRES members indicates that a program aimed specifically at training market conduct examiners would be a welcome addition to IRES's current curriculum," said Bruce Ramge of Nebraska, IRES president-elect

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From the President

Saying Goodbye, but not Farewell

It's been an exciting year at IRES — a year of change, a year of new faces, a year of challenge. And during this year, so many have worked so hard to keep IRES the leader in education. The people listed below made my job as President easier and more exciting. They've brought energy, ideas, and hard work and we can all be proud of the job they've done.

This final column would not be complete without heartfelt thanks to the following people: First, the IRES staff — David, Art, Joy, Susan, and Scott. Their professionalism, patience, and humor serve IRES members well. Moreover, the CDS would be nothing without the hard work of the Section Chairs and the committees. After being a Section Chair for so many years, I know full well the challenges they face. Thank you to everyone who was involved in the CDS — the Chairs, the committees, the speakers, the planners, the telephone callers, the people who scrambled for materials. Without you we could not have put this wonderful CDS together.

Special thanks go to Jo LeDuc as CDS Chair; she pulled a thousand strands together and did it with style and professional grace. Thanks are always due Wayne Cotter for putting together *The Regulator*. His energy and vision brought IRES members both news and thought-provoking articles throughout the year. I could never have survived this year without the hard-working IRES Board of Directors and Executive Committee — Jann Goodpaster, Kirk Yeager, Bruce Ramge, Ed Mailen, Stephen King, Shirley Jones and especially Doug Freeman for his new and innovative ideas that helped refocus us.

Finally, the thanks of the entire IRES Board of Directors and Executive Committee go to all of our members for your support and your energy. I also wish President-elect Bruce Ramge the best of luck during his term in office. I'm sure he'll do an outstanding job. As I leave office, I urge old friends to

continued on next page

President's Column ...

stay involved and encourage new members to actively participate in our organization. Believe me, you'll never regret it.

I started the year saying it's all about the consumer and I'll end the year saying the same thing. Whether we face challenges in market conduct examinations , speed to market, licensing, hardening markets, reinsurance treaties, or financial reports, we need to remember it's still all about the consumer.

We don't regulate the solvency of insurance companies simply to keep them in business; we regulate them so they'll be there to pay consumer claims. We don't license agents just to create more paperwork; we license them to ensure they provide professional, knowledgeable service to consumers. And we don't write claim settlement regulations merely to clutter up our law books; we write them to ensure consumer claims are settled fairly and timely. All that we do revolves around protecting the public.

As Chief of Consumer Services for Vermont, Chair of IRES's Consumer Section, and the outgoing President of IRES, I've tried to put a face on the consumer, give them a voice that can be heard. Remembering those faces and hearing their voices reminds us — it's all about the consumer.

Paul J. Bicica

Paul J. Bicica, CIE
IRES President

Welcome new members

Paul E. Carson, NM
Kirk Cummins, NAIC
Natalee Droge, NAIC
Richard Kramer, OK
Elizabeth D. Mackay, LA
John P. Miller, LA
Ashley T. Natysin, AIE, WI
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Terry R. Smith, TX
Pete Tavares, Jr., KS
David M. Tucker, AIE, CO
Christian Ulmann, AK
Barbara A. Washington, Federal

C.E. News

Attention CDS attendees

Those of you who are attending the CDS in Scottsdale be sure to pick up your attendance certificate. To receive automatic, full (15 hrs) CE credit, you must stay until the end of the CDS. Attendance certificates will not be handed out until 3 p.m. Tuesday, the last day of the CDS. There will be no exceptions made – including travel/flight arrangements. Those who leave early or do not pick up their certificate will be required to submit a NICE compliance reporting form requesting credit for the actual hours attended with a maximum of 12 CE credits available.

Extension Requests

When circumstances prevent you from complying with the current CE program, you may request a one-year extension by completing an extension request form found in your NICE manual or online at www.go-ires.org. The extension request form must arrive to the IRES CE office no later than Sept. 1, 2003.

Captives are captivating — but for how much longer?

by Scott Hoober
Special to *The Regulator*

When the wheel turns and the insurance market turns hard, consumers and insurers react in a variety of mostly predictable ways, from trade associations lobbying for federal relief, to physicians retiring early because their malpractice premiums have risen, to the occasional homeowner deciding to roll the dice and go without homeowner coverage altogether.

In the corporate world, one response has been to turn to the alternative markets: anything from self-insurance to risk-retention groups and purchasing groups to catastrophe bonds to captives.

> ***A captive is basically a formalized self-insurance program.***
>
> **— Leonard Crouse**

Vermont — the biggest U.S. domicile for captive insurance companies (and one of the largest in the world, trailing only Bermuda and the Caymans) — licensed some 75 new captives last year alone.

Yet a few years ago, during the prolonged soft market, when insurance premiums were at near-record lows, the state's Department of Banking, Insurance, Securities and Health Care Administration still averaged 35-40 new captives a year.

Risk Retention Act

Acceptance of captives and other alternatives can be traced to 1981, with passage of the federal Product Liability Risk Retention Act, and 1986, when the act was amended to add commercial liability to product and completed-operations liability.

In 2000, the U.S. Department of Labor approved one captive's request to offer long-term-disability coverage, and it appears likely to approve another corporation's request to use its captive to reinsure its own group life policies. In fact, employee benefits are considered the next frontier for captives.

Something like half the commercial market has migrated to the global alternative-risk-transfer market, up from about 40% in 2000 and 30% in '96, according to figures from A.M. Best. Some fad!

Vermont jumped on board in the earliest days, passing its own state captive statute in '81.

"In the early '80s it was real tough to get insurance," recalls Leonard D. Crouse, Director of Captive Insurance for the Vermont Department. "It was a real hard market.

"If you remember those days, municipalities couldn't open their swimming pools, all these parks were closed — it was really a rough time. So the federal government said, hey, let these companies put together some money and form these group programs.

"You usually see that in a hard market. In a soft market, when insurance is easy to get, you don't really see a lot of group programs. Lately, in the last two years, the market's hardened quite a bit, so you're seeing more group programs being formed."

It might seem as if group captives make the most sense, with corporations in the same industry banding together, perhaps through a trade association, to share the risk and share the cost.

In reality, 85% of the captives domiciled in Vermont are "pure," one-corporation insurers. But when times are good in the insurance market, giving association members more low-cost options, the group captives are the ones that are most likely to go under.

Kate Westover of Captive Advisory Services in Colchester, VT, says group captives tend to exist primarily to find cheaper insurance when markets are hard. When the wheel turns, members drop out, and some of the group captives go out of business.

"They don't have the capital [or the investment income of a traditional insurer] to be able to provide below-cost insurance," she said.

"Often, association members are not really vested in the program," Westover added. "They're going to be hard-market shoppers, and you'll have adverse selection. There are some good association programs, but they're logistically hard to put together."

She and Crouse both agree that the long-term benefits of a captive go beyond low-cost insurance.

Not just premium dollars

"A captive is basically a formalized self-insurance program," explains Crouse.

"If you're a corporation and you self-insure, claims come in and you take the money out of your right pocket and pay the loss. No insurance at all.

"So what some companies do is set up a formalized insurance company, and it's capitalized, and they pay premiums to it, it's got an actuarial study . . . ."

But if self-insurance is so simple, why go through all the rigmarole — and expense — of establishing a captive?

Reinsurance. In the first place, there's access to reinsurance. After all, the only entities reinsurers insure is insurance companies, and if you self-insure — even if you do it the right way, paying premiums and hiring a third-party administrator (TPA) or managing general agent (MGA) — you simply aren't an insurance company.

Of course, that advantage fades in times such as these. As Westover put it, "Access to reinsurance is not very helpful now, because the reinsurance market is hard too."

Low startup costs. Captives cost more than self-insurance, but lots less than establishing a full-fledged insurer.

A traditional insurer may start up with capital and surplus of $5 million. For a captive, says Crouse, the minimum in Vermont is $250,000 — though more typically it's $1 million or more. "We may very well require $2 million, $5 million, $10 million worth of capital, depending on what you're going to write, what your reinsurance program is and all that," he added.

Risk management. American corporations are more and more knowledgeable about assessing and managing their risk, and the word is out that captives can be a good part of the package. Not many years ago, if you asked a brokerage firm about captives, they might not have known what you were talking about, or else bad-mouthed them. No longer.

"These risk managers really know what they're doing," said Crouse.

"They look at the alternatives, they'll look at their programs, they'll see that maybe a captive would be good, they'll talk to a broker — and most of the large brokers in this country have captive management companies in Vermont. Marsh has one here, Aon is here, AIG is here.

> ***"There isn't a large reinsurer in this country, or for that matter in the world, that does not have an arm that's dedicated to alternative markets."***

"And another thing," he added. "There isn't a large reinsurer in this country, or for that matter in the world, that does not have an arm that's dedicated to alternative markets."

Price. Surprisingly, though a corporation can often reduce its costs, captives aren't guaranteed to save money.

"They won't always save you a few bucks," said Westover. "Sometimes they're more expensive than traditional insurance.

"The first thing you have to do, if you're trying to give people good captive advice, is make them realize that there is no such thing as cheap insurance."

Why would a corporation decide to go ahead and form a captive even if the premiums weren't any

continued on next page

How captives captivate the states

continued from preceding page

more favorable than in the commercial market?

Westover explains: "They could decide that even if they've got to invest capital and pay operating costs, over a period of time, as market cycles come and go, they're better off to be insuring the risk in their own captive. At some points a captive could be more expensive, at other points less expensive.

"The main advantage in today's market," she continued, "is that they have to retain more risk anyway in the hard market.

"If they insure within that higher retention, it can be financially advantageous to put it into a captive, rather than keep it on an operating company's books." Not to mention tax breaks, and greater budgetary stability and predictability.

Fortune 500s

But captives aren't for the faint of heart. Small businesses probably wouldn't have the in-house expertise — not to mention the capital — to even consider a captive. No, captive insurers are definitely for the Fortune 500s, the kind of large entities with skilled risk managers on staff.

Even then, they'll end up hiring a consultant like Westover to guide them, plus a management company to handle the financial side (and meet the state's requirement for a local presence, plus a TPA, MGA or other entity to handle claims and the like).

In many ways, Crouse said, captives are regulated the same as other insurers.

"You have to meet with me to talk about your program," he said. "Then you have to get a feasibility program done by an actuary to see if this program is going to be feasible on a loss basis, on a premium basis. Then we meet with you, and your application is sent in.

"It takes 30 days for us to turn it around. What we do is send it out to a reviewing actuary, to make sure that the feasibility study that was done by the initial actuary makes sense. And then you're licensed.

"But everyone doesn't get licensed just because they come here," Crouse added. "I mean, you've got to meet certain criteria, have good capital, have good surplus."

Yet there's one way in which regulation of captives is different from traditional insurance companies: There's next to no need for market-conduct exams.

"A captive isn't writing for the public, it's not writing personal-lines business," Crouse said. "Basically, they're writing their own business."

Not only are captives wholly owned by their customers, those customers tend to be pretty savvy.

As Westover put it: "These are supposed to be sophisticated buyers of insurance, who are able in most states, or at least half the states, to buy nonadmitted insurance, and therefore should be able to make an intelligent buying decision."

Seeing how successful captives have been for Vermont, a number of other insurance departments have passed similar enabling legislation, though so far few have made a great deal of headway. Hawaii and South Carolina, for instance, have jumped in with both feet, and the District of Columbia has gone after association captives. Montana lured one captive away from Vermont with its new captive-friendly law, and Arizona has one too.

As of the end of last year, New York had four captives of its own, and new legislation has been proposed that would make it easier for corporations — and municipalities and other public bodies — to form captives in that state.

Crouse can understand why they'd want the business.

"There's no pollution, there are no buildings," he said. "People come here, set their companies up, they're managed by Vermont management companies — we have 12 of those up in Burlington — and they're all good-paying jobs. I mean, the economic benefit to Vermont is wonderful.

"We're a state of only 650,000 people. So

when you're bringing in all this money and jobs, and no pollution — it's a win-win situation. The Legislature, the executive branch, everyone supports our business."

Terrorism, med mal

Bad news for the insurance industry and their customers often means good news for captives. So whatever widely publicized insurance-related issue that makes CNN or Best's — terrorism coverage, say, or, more recently, med mal — will before long drive someone new to consider a captive.

A good many hospitals, in particular, have set up their own captives to provide staff physicians with medical malpractice coverage. And they often go offshore.

"There's a perception historically that if a hospital system is going to have a captive, you should go to the Caymans," Westover said. "But that's just a historical accident, and in fact there's an awfully good reason for them to do it onshore. The captive industry has historically been suspect by regulators, who viewed them as people who were trying to avoid regulation.

"One benefit of doing your captive business onshore is the absolute certainty that it will be well regulated. There'll be no perception problems, where the offshore domiciles can have bad perception problems."

As for terrorism coverage, since the new federal backstop is aimed at insurers, a self-insured corporation wouldn't have access to federal cash in the event of a terror attack. But, not being an insurer, they also wouldn't have to kick in their share of losses in the event the feds need to assess all commercial insurers.

Westover explains: "You have to say, Am I going to form my captive, and buy some very nominal terrorism coverage from my captive, in order that my captive then is able to access the protection under the federal program?

"Or do I want to put my captive offshore, so that it doesn't get sucked into the whole terrorism issue?"

And we've just scratched the surface. The more we looked into captives, the more complicated they became, with tax implications, federal vs. state regulation and a series of court cases changing the landscape. To cite one example, a pure, one-corporation captive can take on additional business from others, becoming in essence a group captive — with specific limitations.

Westover's advice? "Hire the people to do this right. Otherwise you end up reinventing the wheel and making mistakes.

"If you're going to do it, do it right," she added, "with people who are experienced in what they're doing. That's probably one reason why the domiciles like to have the authorized managers, because the authorized managers have the experience."

Westover may have been looking for business when she said that, but even if she is, it sounds like good advice.

Captives may seem like a logical concept whose time has come. But they're not nearly as simple as they sound at first, whether we're talking about evaluating them, setting them up or living with them through good times and bad.

And corporations need to understand that captives are a long way from being turnkey operations that will run like clockwork, with little effort or attention.

"The captive's there to utilize, for your benefit," Crouse said. "Utilize it when you need to, and when you're getting a better deal in the commercial market, take it." ■

Top Captives Worldwide

Domicile	*Number*
Bermuda	1,157
Cayman Islands	599
Vermont	443
Guernsey	383
British Virgin Islands	282
Barbados	239
Luxembourg	230
Dublin	181
Isle of Man	167
Turks and Caicos	143

Excluding credit life insurers
Source: Business Insurance, 2002 data

Regulators: Come to Scottsdale to learn, learn, learn

by Stephen E. King, CIE
Education Committee Chairperson

What do you mean you haven't registered for the 2003 CDS?? Well, it's not too late . . . but you better hurry.

Being the optimistic sort, I am hopeful that many of you who have put off registering, for whatever reason, will have a change of heart.

Once again, this annual event has all the earmarks of being one of the most informative and exciting seminars that we have held in recent years. I am confident that as you return home, you will be gratified with the knowledge and information that you will have gained.

The 2003 IRES Career Development Seminar

July 27-29, 2003
Hyatt Regency, Scottsdale
What to do for fun?
See related story p. 16

In a nutshell, we will feature a very interesting, thought-provoking seminar that will be held at the beautiful Hyatt Gainey Ranch in Scottsdale, AZ. It doesn't get any better than this!

Jo LeDuc, our 2003 CDS chairperson, has painstakingly, ensured that this CDS will exceed your expectations. Her efforts in coordinating the overall program, coupled with the hard work of the section chairs, promises a most enlightening two days of information sharing.

We will kick off the Scottsdale CDS with our Sunday evening reception. This informal get-together provides attendees the opportunity to renew old friendships and acquaintances and to gossip about those not attending. Based on current numbers, we are expecting well over 400 participants this year.

Beginning on Monday, the Opening General Session will feature the Commissioners Roundtable, with Commissioners from the states of Arizona, Arkansas, Florida and Kansas. This session always provides some very interesting insights from Commissioners. We are fortunate to have as our luncheon keynote speaker Arkansas Commissioner & NAIC President Michael Pickens. Additionally, in keeping with timely issues, the Tuesday morning General Session will include a discussion of insurance companies' use of third-party vendors.

However, as always, the meat of the CDS program is our 30 workshops. Topics include, suitability, credit scoring, mold (an annual favorite), the NAIC Market Conduct Examiners Handbook, and the federal terrorism insurance bill. Specific program information and a registration form may be found on the IRES Web site at www.go-ires.org.

Our CDS is successful, in large part, due to the knowledge and quality of our presenters. Year after year, our presenters — both volunteers and recruits —devote a significant amount of effort to prepare and present their topics. I would like to thank each of this year's presenters for their hard work. Their contributions virtually guarantee that this year's CDS will be a success.

Lastly, I congratulate Jo for her untiring efforts to ensure that the 2003 Career Development Seminar will be one to remember.

I look forward to seeing everyone in Scottsdale.

Oh yes, one last thing, I understand that you won't need an overcoat, but be sure and pack the sunscreen and a swimsuit. ■

The impact of corporate governance and financial scandals on insurance regulation

by New York State Senator William J. Larkin, Jr., and J. Stephen Casscles

Recent accounting, corporate governance and insider-trading financial scandals have served to highlight systemic deficiencies that exist in the regulation of this nation's stock exchanges and the financial services industry.

Perhaps, more importantly, these scandals demonstrate that the federal government, the primary regulator of these key activities, was asleep at the wheel over the past few years.

Had the federal government been aware of the significant conflicts of interest that were driving these scandals, thousands of small independent investors, large institutional investors and insurance companies would have been spared devastating losses to their portfolios.

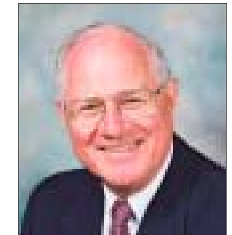
The Securities and Exchange Commission (SEC), along with the U.S. Treasury Department, are the primary regulators of this nation's financial services industry and stock exchanges. It is the SEC's responsibility to ensure that accurate corporate financial disclosure statements are prepared and made available to the public so that investors can make informed decisions on the stocks that they purchase.

The SEC also has supervisory powers over those that prepare financial disclosure statements such as auditors, attorneys and other financial analysts. The SEC's regulatory charge is to protect all investors from fraudulent insider trading or other conflicts-of-interest that can hinder the optimal operation of a free marketplace. In sum, the SEC's job is to place both small and large investors on a level playing field so that a fair securities market can properly function.

Unfortunately, due to the SEC's inability to properly regulate the market over the past four years, the amount of money lost by both small and institutional investors has been staggering. For example, approximately 11,000 Enron employees lost nearly $600 million in their retirement plans in less than one year. The New York State Public Employees Retirement Fund alone lost $58 million due to Enron's demise.

New York State Senator William J. Larkin, Jr. is Past President of the National Conference of Insurance Legislators. J. Stephen Casscles is Counsel to Senator Larkin. The authors would like to thank Mark Gardner of General Star for his editorial assistance.

Two events led to Enron's failure. First, its liberal use of risky derivatives which allowed it to generate paper income. Second, the practices of its auditor, Arthur Andersen, which allowed the company to manipulate profits and falsely value assets — to the tune of $1 billion — in order to mask losses in its derivatives operations.


State Sen. Larkin

WorldCom topped Enron's infamy when it was revealed that its auditors apparently hid anywhere from $3.8 to $7 billion in expenses to boost profits. WorldCom's stock imploded in value, dropping from $16 per share to 83 cents per share within one year. The total loss to investors not privy to insider information has been estimated to be approximately $45 billion.

Washington's inability to properly regulate corporate activities is demonstrated by the long list of corporations that have recently been accused of illicit accounting, insider trading, or other fraudulent acts. The list includes some of America's largest corporations, including Rite Aid, Adelphia, ImClone, Xerox, WorldCom, Tyco, Dynergy, Cendant, W.R. Grace, Sunbeam, Lucent, and Oxford Health Plans.

As noted above, accounting firms helped push Enron and WorldCom off the financial precipice. Accounting firms are duty bound to accurately evaluate a public corporation's business assets and liabilities, and to honestly disclose the financial condition of such corporation to the SEC and to the public. However, some accounting firms received four times the amount of money in consulting fees from their client companies than they were paid for their

continued on next page

Financial scandals and insurance regulation

continued from previous page

auditing services. Some accounting firms put themselves in harm's way by helping corporations to develop business plans that included work that put their client's books in the best light possible in order to attract investors.

On Wall Street, we are learning that many prominent investment and brokerage houses, such as Merrill Lynch, Goldman Sachs, Morgan Stanley, Solomon Smith Barney, and First Boston also may have engaged in conflict of interest activities. It seems these firms allowed their stock analysts to benefit financially for publicly praising certain risky securities. Further, these brokerage firms allowed their analysts to inappropriately promote stocks of companies whose investment banking business the firm was trying to secure.

What was Washington doing?

The litany of fraudulent acts committed by Wall Street during the roaring 1990s begs the question: — What was Washington doing to protect the public interest? Did the federal government know of the scope of the illicit activity that was occurring on Wall Street and in corporate board rooms, but was incapable to act?

Or, was it an unwitting regulator that was not even aware these questionable practices were occurring? Either way, the federal government in general, and the SEC and Treasury Department in particular, should be concentrating on reforming how it regulates the securities industries. More importantly, Washington should not be empowered to expand its scope of regulatory authority to include the insurance industry.

Impact on insurance industry

There are two reasons why Washington's inattention to and the mismanagement of the corporate governance and financial scandals of the past few years and the proper regulatory resolution of these matters are of the utmost importance to the insurance industry.

First, some of the largest institutional investors are insurers managing tens of billions of dollars in investment portfolios. The need for transparency and meaningful disclosure of conflicts of interest in the financial markets is imperative to the knowledgeable investment of insurer capital. The SEC must be more vigilant in monitoring the form and content of corporate financial disclosure statements. The prudent management of these portfolios is essential to ensure that an insurer's assets are available when needed to cover losses. Also, an insurer's income is based on two major components: investment and premiums collected. If return on capital proves to be significantly below expectations, premium rates are likely to rise for all consumers.

Second, when banks, accounting firms and other business corporations engage in fraudulent activities, fail to disclose serious conflicts of interest, or engage in insider trading, many times the entities that ultimately pay for their mistakes are insurers that issue Directors & Officers (D&O) liability insurance and Errors & Omissions (E&O) policies.

Already, corporate officers and board members at Enron, WorldCom and other corporations are facing derivative stockholder actions to compensate stockholders and other investors for the substantial losses caused by the illicit activities of these officers and directors. Insurers clearly have a financial stake in ensuring that corporate practices are legally conducted and that conflicts of interest are minimized.

Filling a regulatory void

In the past year, the states have filled, to the extent they could, the regulatory void left by the federal government and the SEC. For example, on May 22, 2002, the New York State Attorney General settled a lawsuit with Merrill Lynch for violation of New York's Martin Act. This broad state law bars fraud in the sale or offering of securities. Over 40 other states have similar "Blue Sky" laws on the books. These laws give states a useful tool to help protect their citizens from the fraudulent sale of securities.

In the Merrill Lynch settlement, the firm agreed to pay $100 million in penalties to New York, other states and the North American Securities Administrators Association (NASAA). The settlement also required Merrill to institute procedures to separate analysts' pay from the firm's investment banking business, form a new committee to oversee the objectivity of stock picks recommended for sale to investors, and create a system to monitor e-mail between investment bankers and stock analysts.

As a follow-up to the Merrill Lynch settlement, in December 2002, the State of New York, along with 49 other states and the SEC, entered into a settlement agreement with other major Wall Street firms, including Goldman Sachs, Morgan Stanley, and

Solomon Smith Barney. The firms agreed to pay $ 1 billion in fines, $450 million (over five years) for independent research for investors, and an additional $85 million to establish a nationwide investor education program.

In addition, in a joint statement, the New York State Comptroller and the Treasurers from California and North Carolina announced that they will now require all money managers of their employee pension funds to independently scrutinize the accounting practices and governance structures of a company prior to purchasing its stock. Money managers will also be required to minimize and disclose their conflicts of interest and make trades through brokerage firms that comply with standards laid out in the Merrill Lynch settlement.

The appropriate level of government

The current regulatory scheme and mix of governmental agencies that monitor the banks, securities and insurance industries is fitting. For the banking and securities industries, it is appropriate to have a dominant Washington-based regulator with states exercising limited ancillary powers when needed to protect its citizens. In contrast, for the insurance industry, having a dominant state-based regulatory system with Washington possessing limited ancillary powers is appropriate and in the public's best interest.

For the banking/securities industries, it is suitable for Washington to be the primary regulator because their products are largely fungible, with few variations within a product line. Those variations may include, interest rate, length of term, and procedures for redemption. Therefore, regulating these products on a nationwide basis makes sense.

In contrast, insurance products tend to be complex contracts providing a wide array of coverages. In addition, each state's tort and common law heritage may lead to identical insurance policy contracts being interpreted in different ways in different states. For insurance products, it is fitting for the states to be the primary regulator of these products.

Washington's recent past history in overseeing stock exchanges, auditors and banks coupled with the inherent differences among each industry's core products strongly indicate that Washington should tend to its own problems and not expand its scope of power to include the regulation of insurance. ■

Quotes of the Month

"No one understands what the heck this bill says or will do."

— Senator Judd Gregg (R-NH) commenting on the new federal Medicare drug bill prior to its passage.*

"The history of most great social legislation in our country, including Medicare and Medicaid, is ready, fire, aim. The difference here is that there's such sharp disagreement about the direction we are aiming in."

— Drew Altman, President of the Kaiser Family Foundation, commenting on the same bill.

* On June 27, 2003, the Senate's version of the Medicare drug bill passed 76 to 21. On the same day, the House's version also passed, but by a much narrower margin, 216-215. Over the summer, Congress will be drafting a compromise version of the two bills.

Warren Buffet: Derivatives as time bombs?

continued from page 1

It will be a great many years before we are totally out of this operation (though we reduce our exposure daily). In fact, the reinsurance and derivatives businesses are similar: Like Hell, both are easy to enter and almost impossible to exit. In either industry, once you write a contract – which may require a large payment decades later – you are usually stuck with it. True, there are methods by which the risk can be laid off with others. But most strategies of that kind leave you with residual liability.

Another commonality of reinsurance and derivatives is that both generate reported earnings that are often wildly overstated. That's true because today's earnings are in a significant way based on estimates whose inaccuracy may not be exposed for many years.

Errors will usually be honest, reflecting only the human tendency to take an optimistic view of one's commitments. But the parties to derivatives also have enormous incentives to cheat in accounting for them. Those who trade derivatives are usually paid (in whole or part) on "earnings" calculated by mark-to-market accounting. But often there is no real market (think about our contract involving twins) and "mark-to-model" is utilized. This substitution can bring on large-scale mischief.

As a general rule, contracts involving multiple reference items and distant settlement dates increase the opportunities for counterparties to use fanciful assumptions. In the twins scenario, for example, the two parties to the contract might well use differing models allowing both to show substantial profits for many years. In extreme cases, mark-to-model degenerates into what I would call mark-to-myth.

Of course, both internal and outside auditors review the numbers, but that's no easy job. For example, General Re Securities at yearend (after ten months of winding down its operation) had 14,384 contracts outstanding, involving 672 counterparties around the world. Each contract had a plus or minus value derived from one or more reference items, including some of mind-boggling complexity. Valuing a portfolio like that, expert auditors could easily and honestly have widely varying opinions.

The valuation problem is far from academic: In recent years, some huge-scale frauds and near-frauds have been facilitated by derivatives trades. In the energy and electric utility sectors, for example, companies used derivatives and trading activities to report great "earnings" – until the roof fell in when they actually tried to convert the derivatives-related receivables on their balance sheets into cash. "Mark-to-market" then turned out to be truly "mark-to-myth."

I can assure you that the marking errors in the derivatives business have not been symmetrical. Almost invariably, they have favored either the trader who was eyeing a multi-million dollar bonus or the CEO who wanted to report impressive "earnings" (or both). The bonuses were paid, and the CEO profited from his options. Only much later did shareholders learn that the reported earnings were a sham.

> ***"Another commonality of reinsurance and derivatives is that both generate reported earnings that are often wildly overstated."***

Another problem with derivatives is that they can exacerbate trouble that a corporation has run into for completely unrelated reasons. This pile-on effect occurs because many derivatives contracts require that a company suffering a credit downgrade immediately supply collateral to counterparties. Imagine, then, that a company is downgraded because of general adversity and that its derivatives instantly kick in with *their* requirement, imposing an unexpected and enormous demand for cash collateral on the company. The need to meet this demand can then throw the company into a

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Warren E. Buffet is CEO and Chairman of the Board of Berkshire Hathaway. This article is excerpted from Mr. Buffet's 2003 Letter to Berkshire Shareholders and is reprinted with permission.

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liquidity crisis that may, in some cases, trigger still more downgrades. It all becomes a spiral that can lead to a corporate meltdown.

Derivatives also create a daisy-chain risk that is akin to the risk run by insurers or reinsurers that lay off much of their business with others. In both cases, huge receivables from many counterparties tend to build up over time. (At Gen Re Securities, we still have $6.5 billion of receivables, though we've been in a liquidation mode for nearly a year.) A participant may see himself as prudent, believing his large credit exposures to be diversified and therefore not dangerous.

Under certain circumstances, though, an exogenous event that causes the receivable from Company A to go bad will also affect those from Companies B through Z. History teaches us that a crisis often causes problems to correlate in a manner undreamed of in more tranquil times.

> ***"History teaches us that a crisis often causes problems to correlate in a manner undreamed of in more tranquil times."***

In banking, the recognition of a "linkage" problem was one of the reasons for the formation of the Federal Reserve System. Before the Fed was established, the failure of weak banks would sometimes put sudden and unanticipated liquidity demands on previously-strong banks, causing them to fail in turn.

The Fed now insulates the strong from the troubles of the weak. But there is no central bank assigned to the job of preventing the dominoes toppling in insurance or derivatives. In these industries, firms that are fundamentally solid can become troubled simply because of the travails of other firms further down the chain. When a "chain reaction" threat exists within an industry, it pays to minimize links of any kind. That's how we conduct our reinsurance business, and it's one reason we are exiting derivatives.

Many people argue that derivatives reduce systemic problems, in that participants who can't bear certain risks are able to transfer them to stronger hands. These people believe that derivatives act to stabilize the economy, facilitate trade, and eliminate bumps for individual participants. And, on a micro level, what they say is often true. Indeed, at Berkshire, I sometimes engage in large-scale derivatives transactions in order to facilitate certain investment strategies.

Charlie and I believe, however, that the macro picture is dangerous and getting more so. Large amounts of risk, particularly credit risk, have become concentrated in the hands of relatively few derivatives dealers, who in addition trade extensively with one another. The troubles of one could quickly infect the others. On top of that, these dealers are owed huge amounts by non-dealer counterparties.

Some of these counterparties, as I've mentioned, are linked in ways that could cause them to contemporaneously run into a problem because of a single event (such as the implosion of the telecom industry or the precipitous decline in the value of merchant power projects). Linkage, when it suddenly surfaces, can trigger serious systemic problems.

Indeed, in 1998, the leveraged and derivatives-heavy activities of a single hedge fund, Long-Term Capital Management, caused the Federal Reserve anxieties so severe that it hastily orchestrated a rescue effort. In later Congressional testimony, Fed officials acknowledged that, had they not intervened, the outstanding trades of LTCM – a firm unknown to the general public and employing only a few hundred people – could well have posed a serious threat to the stability of American markets. In other words, the Fed acted because its leaders were fearful of what might have happened to other financial institutions had the LTCM domino toppled. And this affair, though it paralyzed many parts of the fixed-income market for weeks, was far from a worst-case scenario.

One of the derivatives instruments that LTCM used was total-return swaps, contracts that facilitate 100% leverage in various markets, including stocks. For example, Party A to a contract, usually a bank, puts up all of the money for the purchase of a stock while Party B, without putting up any capital, agrees that at a future date it will receive any gain or pay any loss that the bank realizes.

continued on next page

Buffet: Derivatives as time bombs?

continued from previous page

Total-return swaps of this type make a joke of margin requirements. Beyond that, other types of derivatives severely curtail the ability of regulators to curb leverage and generally get their arms around the risk profiles of banks, insurers and other financial institutions. Similarly, even experienced investors and analysts encounter major problems in analyzing the financial condition of firms that are heavily involved with derivatives contracts. When Charlie and I finish reading the long footnotes detailing the derivatives activities of major banks, the only thing we understand is that we *don't* understand how much risk the institution is running.

The derivatives genie is now well out of the bottle, and these instruments will almost certainly multiply in variety and number until some event makes their toxicity clear. Knowledge of how dangerous they are has already permeated the electricity and gas businesses, in which the eruption of major troubles caused the use of derivatives to diminish dramatically. Elsewhere, however, the derivatives business continues to expand unchecked. Central banks and governments have so far found no effective way to control, or even monitor, the risks posed by these contracts.

Charlie and I believe Berkshire should be a fortress of financial strength – for the sake of our owners, creditors, policyholders and employees. We try to be alert to any sort of megacatastrophe risk, and that posture may make us unduly apprehensive about the burgeoning quantities of long-term derivatives contracts and the massive amount of uncollateralized receivables that are growing alongside. In our view, however, derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal. ■

Oregon — Our May meeting featured three guest speakers. The first was Oregon Department of Transportation representatives **Penny Long** and **Kelly Kercheski**, who discussed SR22 filings. The second was **Joyce Riggi** of the Oregon Health Plan who gave an overview of the plan and its benefits. The third was **Jann Goodpaster** of the Oregon Insurance Division. She provided an overview of the NAIC database and its capabilities. The June meeting featured State Farm representative **Scott Kramer**, who discussed terrorism and nuclear exclusions in policies. **Steve Meulemans** from State Farm discussed mold claims in Oregon. The third speaker in June was Complementary Healthcare Plans representative **Andrea Gioia** who discussed the coverage provided by their policies.
— Gary Holliday

Virginia — Twenty-one members of the Virginia IRES Chapter recently attended a continuing education session. Two staff members of the Bureau of Insurance discussed the Bureau's insurance outreach activities. They outlined how the Bureau interacts with Virginia consumers to make them aware of the Bureau's purpose and how it can help with questions and problems they are experiencing with their insurance carriers. The next meeting, tentatively scheduled for August, will focus on gathering topics for upcoming chapter meetings.
— Catherine West

Colorado — We have elected the following new officers: President – **Tom Abel**, Vice President – **Vi Pinkerton**, Secretary – **Dayle Axman**, and Treasurer – **Jeff Olson**. At our May IRES-sponsored training session, **Victoria Lusk**, the Colorado Division of Insurance's Chief Actuary, presented a session on mold and its impact on homeowners insurance. We are in the process of finalizing the dates for upcoming classes on e-commerce, long-term care, reinsurance, confidentiality and access to insurer information and guaranty funds.
— Dayle Axman

Nebraska — The Nebraska IRES Chapter's June meeting featured **Jessica Fuchs**, Consumer Specialist with the Nebraska Office of the Attorney General. Ms. Fuchs discussed identity theft and first- and third-party collectors. She also addressed scams frequently reported to their office. The next chapter meeting will be in August. — Karen Dyke

IRES to develop new market conduct ‘certification’ course

continued from page 1

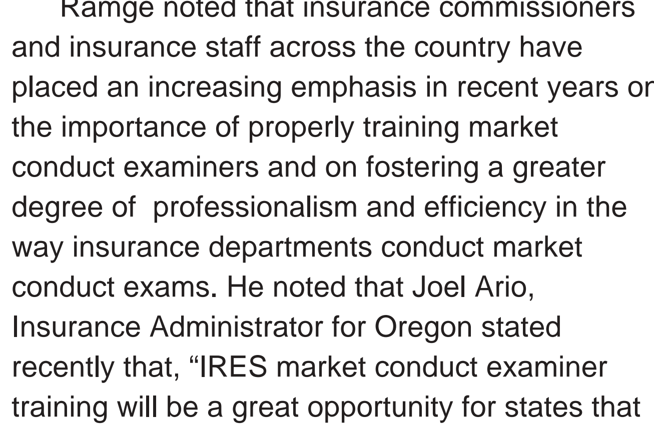
and chairperson of the Society’s Accreditation and Ethics Committee.

The first step in developing the program, Ramge said, will take place July 26 in Scottsdale, Ariz., in conjunction with the annual IRES Career Development Seminar, at the Hyatt Regency Gainey Ranch Hotel. A select group of experienced examiners will gather to review the types of job skills and training that should be included in a market conduct certification program. The feedback gathered at the Scottsdale meeting, he said, will be used to take the project to the next phase, namely, designing a formal curriculum and budget.

Ramge stressed that no decisions have been made about how to implement a market conduct certification program. He said the IRES Board and Executive Committee will make every effort to seek input and suggestions from both regulators and industry experts. “We are an educational society and we exist to create educational and professional development opportunities for our members,” he said. “We hope that this project will result in a valuable new addition to our educational repertoire.”

> ***We are an educational society and we exist to create educational and professional development opportunities for our members. We hope that this project will result in a valuable new addition to our educational repertoire.***
>
> — Bruce Ramge, IRES

The Society currently issues the Accredited Insurance Examiner and Certified Insurance Examiner designations. Much discussion will be needed, he said, before determining how the new market conduct project will be incorporated into the existing AIE and CIE curriculum, or whether a new specialty designation may be created for market conduct examiners.



Ramge noted that insurance commissioners and insurance staff across the country have placed an increasing emphasis in recent years on the importance of properly training market conduct examiners and on fostering a greater degree of professionalism and efficiency in the way insurance departments conduct market conduct exams. He noted that Joel Ario, Insurance Administrator for Oregon stated recently that, “IRES market conduct examiner training will be a great opportunity for states that are working on achieving more uniformity in the examination process. Training opportunities such as this will enhance our ability to effectively monitor the insurance marketplace.”

The need for a new market conduct training program at IRES, Ramge said, is the result of extensive discussion in recent years by the IRES Accreditation & Ethics Committee as well as extensive input received from the IRES Past President’s Council. He thanked both the Accreditation Committee and the Past President’s Council for its work on this topic.

Ramge also extended appreciation to IRES Past President Gary Domer, an independent examiner, for supervising and planning the special program to be held in Scottsdale. He also thanked Lynette Baker of the Ohio Insurance Department and Shelly Schuman of the National Association of Insurance Commissioners for their assistance on the project.

“The good work and planning by all these professionals is really appreciated,” Ramge said. “I’m encouraged to see that IRES is keeping abreast of the challenges posed by modernization of insurance regulation.” ■

Welcome to the "West's Most Western Town" — Scottsdale

by Carol Hogan

Whether it's browsing Downtown Scottsdale's famous Fifth Avenue Shops, finding a special treasure at one of our not-to-be missed art galleries, or taking a gondola ride on the scenic waters encompassing the fabulous **Gainey Ranch** (where the CDS is being held this year), the "West's Most Western Town" welcomes you to experience the desert at its finest — oh, don't worry — it's a dry heat.

You can capture the gypsy spirit at the passionate Flamenco dance show at **Mosaico** at the Hyatt (7500 E. Doubletree Ranch Rd.), or listen to Latin rhythms wafting through the lobby show bar, feast on the finest prime rib in the West at the **Pink Pony** (3831 N. Scottsdale Rd.), have a "Big Ass" burger at the **Roaring Fork** (4800 N. Scottsdale Rd.), or a two pound porterhouse at the **Stockyards** (5001 E. Washington, Phoenix). Once the world's largest working feed lot, the Stockyards oozes of history from the 1889 bar to the original murals and photographs on the walls.

Be sure to look across the street to see the beautiful **Tovrea Castle** built in the 1920s and shaped like a wedding cake! You can find live jazz and a great menu at **Remington's** (7200 N. Scottsdale Rd.), rock 'n' roll at the **Martini Ranch** (7295 E. Stetson) or listen to live Country Music seven nights a week at **Handlebar "J"** (7116 E. Becker La.). Fond of Italian food? **Veneto Trattoria** at the Hilton Village (6137 N. Scottsdale Rd.) will make you think you're in Italy.

El Chorro Lodge (corner of 56th Street and Lincoln Dr.), on the other hand, sits on 22 desert acres in Paradise Valley and is the essence of the "old West." Built in 1934 by John C. Lincoln as the Judson School for Girls because Lincoln wanted a school for his daughter to attend. It was converted to a lodge and dining room in 1937 and is one of the oldest restaurants in the area.

Steak lovers will enjoy the **Fleming's Prime Steakhouse and Wine Bar** (6333 N. Scottsdale Rd.) or the classic hacienda style setting of **Harris' Restaurant** in Phoenix (3101 E. Camelback Rd.), specializing in bone-in sirloins. Feel like trying a sports bar? Scottsdale boasts the best in the West! With 37 televisions, wide projection TV, and the "plate with more stuff," **Dukes Sports Bar** at the southeast corner of McDowell and Miller is a must.

Speaking of sports, the 2001 World Champion **Arizona Diamondbacks**' only game during your stay is Sunday afternoon, July 27, against the Los Angeles Dodgers. If you decide to come early, tickets are available by calling (602) 514-8400, 1-888-777-4664 or online at www.azdiamondbacks.com.

Or you can just shop 'til you drop at the indoor **Scottsdale Fashion Square**. Offering valet parking, 225 retailers, including Nordstroms, Dillards, Neiman Marcus, Robinson-May and Macys, Fashion Square has two luxury cinema complexes and seven restaurants.

Old Scottsdale offers the finest in Indian jewelry, turquoise, Western art, attire and accessories at shops such as **Gilbert Ortega** (7155 E. Fifth Ave. and 7237 E. Main St., with a Museum Gallery at 3925 N. Scottsdale Rd.), **Saba's Western Wear** (3965 N. Brown Ave.), and many shops scattered throughout Main Street and First Avenue such as **Brown House Antiques** and the **Old Territorial Shop**. For art lovers, galleries

The 2003 Insurance Regulatory Examiners Society
CAREER DEVELOPMENT SEMINAR

JULY 27-29, 2003
HYATT REGENCY SCOTTSDALE

Carol Hogan, wife of Paul J. Hogan (AIE, IRES State Chair), lives and works in Phoenix.

abound throughout Main Street, Fifth Avenue and Marshall Way.

All through shopping? Try 90 minutes of pure bliss for your feet at **Spa du Soleil** (7040 E. Third Ave.), one of the 25 treatment rooms at the **Spa at Gainey Village**, or a new hair-style, massage and body wrap at **Spa Nordstrom** in Scottsdale Fashion Square.

Finally, don't forget about the **Phoenix Zoo** located just outside Scottsdale at 455 N. Galvin Parkway or the **Desert Botanical Gardens** just North of the Zoo.

Enjoy Scottsdale! We promise — you won't be disappointed.

Remember these heat tips when the temperature is 100 and above and you'll have a hot time in the city while staying very comfortable:

• Water, Water, Water. Drink plenty and you'll feel much cooler. Wear white or light colored clothing.

• Use sun screen of SPF 30 and above. Wear a hat (very stylish) and definitely sunglasses.

• Park in the shade, if you can, and cover your steering wheel with a towel (borrow one from the hotel) or learn to drive with two fingers! Borrow another towel for that leather seat if you're going to wear shorts!

• Remember, you can always wander around the Hyatt and Gainey Ranch pools or take a quick dip.

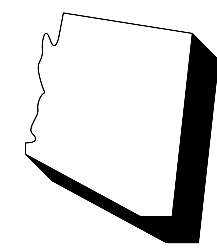
Registering Late?

Hotel Rooms: You must book your hotel room directly with the Hyatt Regency Scottsdale. The room rate for IRES attendees is $135 per night for single-double rooms. Call group reservations at 480-991-3388. See the hotel's web site at http://scottsdale.hyatt.com

Seating for all events is limited. IRES reserves the right to decline registration for late registrants due to seating limitations.

Did you know?

Arizona comes from the Indian "Arizonac" meaning "little spring" or "young spring" and covers 113,635 square miles.



Some famous Arizona natives include: Zane Grey, Steven Spielberg, Wonder Woman Lynda Carter, Erma Bombeck, Alice Cooper, Ira Hayes, Waylon Jennings, Glen Campbell, Walter Winchell, Arizona Diamondbacks pitcher Curt Schilling, cartoonist Bill Keane, architects Paolo Soleri and Frank Lloyd Wright, Apache Chief Cochise, Marty Robbins, Supreme Court Justice Sandra Day O'Connor, Andy Devine, Tom Mix, Rex Allen, and the "Baron of Arizona" James Addison Reavis.

The Hyatt Gainey Resort in Scottsdale: a wonderland of relaxation, swimming pools and outdoor recreation

NEED HELP?
Call the IRES office at 913-768-4700. Or see the IRES Web site: www.go-ires.org

REGULATORY ROUNDUP

by Stroock & Stroock & Lavan LLP

ARIZONA— Governor signs credit scoring legislation

Governor Janet Napolitano signed into law House Bill 2032 on May 6, 2003. The new law governs the use of credit related information in the underwriting of certain property/casualty coverages. Existing law already imposes restrictions on the use of credit related information by property/casualty insurers. Currently, any insurer making an adverse underwriting decision based on credit related information must provide specified details regarding the adverse underwriting decision. House Bill 2032 deletes certain items from the existing list of information that must be provided to consumers. For example, an insurer will no longer be required to provide a list of six specified items (*e.g.*, past due balances, etc.) relative to an individual's credit history that could affect the consumer report. However, insurers will now be required to provide a description of up to four factors that were the primary cause for the adverse action that resulted from an insurance score. Additionally, House Bill 2032 provides that an insurer may not use specified types of credit history to calculate an insurance score that is used to determine certain property/casualty premiums and may not knowingly use an insurance score developed by a third party if the score is calculated using specified types of credit history. For example, the credit score may not be based on the absence of credit history or the inability to determine an individual's credit history, except where the insurer's action is actuarially justified or the consumer is treated as if he or she had neutral credit information. Additionally, the credit score may not be based on a bankruptcy or a lien satisfaction that is more than seven years old. The law is effective on August 31, 2004. *To view House Bill 2032, visit www.azleg.state.az.us.*

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 Priya N. Pooran, an associate in the group. This column is intended for informational purposes only and does not constitute legal advice.

CALIFORNIA— Senate introduces legislation that would not unfairly penalize property insureds for inquiries that do not lead to claims

The California Senate recently introduced Senate Bill 64 affecting certain types of property insurance. Among other provisions, the bill would amend California Insurance Code Section 791.12(b), which prohibits insurers and agents from refusing to offer or renew certain types of property coverage due to inquiries about policy coverage or notifications of a loss by an insured to an insurer, except where such inquiries or notifications are intended by the insured to be a claim under the policy.

Currently, Section 791.12(b) requires an insurer to obtain written evidence from the insured within 30 days of the opening of a claim substantiating that a claim was made by the insured. Senate Bill 64 would apparently eliminate this 30-day time frame and would require instead that a claim be evidenced "by written or electronically recorded evidence sufficient to demonstrate that an insured intended to make a claim under a policy."

The proposed bill sets forth a detailed list of the types of evidence that would be deemed sufficient to meet this standard. Senate Bill 64 would also prohibit any refusal to renew coverage on certain types of property except on certain bases, such as fraud or material misrepresentation.

Violation of this provision would constitute an unfair method of competition and unfair and deceptive act or practice in the business of insurance.

The proposed legislation would also prohibit an insurer from using credit ratings, credit reports, credit scoring models or credit information to underwrite, classify or rate insurance policies that are subject to California Insurance Code Section 675. Similarly, no insurer would be permitted to refuse to issue or to nonrenew or cancel an insurance policy based on credit ratings, credit reports, credit scoring models or credit information. *To view Senate Bill 64, visit www.sen.ca.gov.*

MICHIGAN — Insurance Commissioner issues bulletin regarding insurance credit scoring practices

Michigan Insurance Commissioner Linda A. Watters has issued Insurance Bureau Bulletin 2003-2 regarding insurance credit scoring. The Bulletin, issued May 13, 2003, opens with a list of technical and social issues germane to the use of insurance credit scoring. The Bulletin states, for example, that there are serious errors in approximately 30% of the credit history files used to calculate a credit score and that an individual's credit score may vary by as much as 40 points, depending on the credit reporting agency reporting. The Bulletin also notes that Michigan Governor Jennifer M. Granholm has introduced legislation to ban the use of insurance credit scoring in the rating of automobile and homeowners insurance. Until such a ban is enacted, the Commissioner chose to revise Bulletin 2003-1, which also addresses credit scoring practices, to more fully address under current law the concerns associated with credit scoring.

Accordingly, the Bulletin amends the third directive in Bulletin 2003-01 to read as follows: "At the request of an insured, a company using an insurance credit scoring discount must recalculate and then apply the insured's insurance credit score at least once annually." This directive previously required an insurer to recalculate even in the absence of the request of an insured. This revision takes into account the fact that an individual who does not believe that his or her score has improved is unlikely to want or need a recalculation. To ensure that consumers are well informed with respect to their credit score and discount tiers, the Bulletin reiterates the importance of insurer compliance with the seventh directive of Bulletin 2003-1. The seventh directive requires insurers using credit scoring to annually inform their automobile and homeowners insurance policyholders or applicants of the credit score used to apply an insurance credit scoring discount, and the tier in which the insured or applicant is placed.

The Bulletin states that insurers must achieve compliance with these directives by July 1, 2003, or as soon thereafter as practicable. The Bulletin also reminds insurers of their responsibility to inform applicants of any adverse action relating to the use of credit histories in the rating or underwriting of insurance. *To view Bulletin 2003-2, visit www.michigan.gov/cis/0,1607,7-154-10555_12900-67924—,00.html.*

SOUTH CAROLINA—Insurance Commissioner issues bulletin on the use of electronic commerce in connection with the business of insurance

Insurance Commissioner Ernst N. Csiszar issued Bulletin 5-2003 on April 24, 2003 to provide the insurance community with information regarding the use of electronic commerce in the transaction of insurance business. The Bulletin highlights various federal and state statutes affecting the electronic transaction of the business of insurance. The Bulletin notes that, because South Carolina did not enact the Uniform Electronic Transactions Act, there is uncertainty whether the South Carolina Electronic Commerce Act (SCECA) is preempted in whole or in part by the federal Electronic Signatures in Global and National Commerce Act (E-Sign Act). The Bulletin further states that "insurance forms may be electronically created and signed and transmitted or delivered, PROVIDED the electronic methodology implemented meets the criteria imposed by applicable law." The Bulletin reminds insurers and other licensees to consider laws in addition to the SCECA or the E-Sign Act. *To view Bulletin 5-2003, visit www.doi.state.sc.us*.

NEW YORK—New York State Small Business Health Insurance Partnership Program (NYSHIPP) to terminate

NYSHIPP, a program aimed at assisting small businesses in buying health insurance coverage for employees and their dependents by subsidizing the premium rate, will end June 30, 2003 in accordance with the Health Care Reform Act of 2000. Although premium subsidies will end on that date, the termination of the program does not mean that group health insurance contracts purchased by NYSHIPP businesses will end. Unless such contracts are terminated by the policyholder, insurer, HMO or Article 43 corporation for one of the permitted bases, they will continue in force for as long as the premium is paid. NYSHIPP participants have been advised by the Department of Health of their conversion rights and of their eligibility to participate in the Healthy NYprogram. The program helps small business owners, sole proprietors and working people without insurance obtain comprehensive health insurance coverage. Such businesses may no longer meet the definition of a group for the purpose of insurance after the termination of NYSHIPP. If coverage is terminated for failure to meet the definition of a group, the insurer, HMO or Article 43 corporation must allow the sole proprietor to purchase an individual direct pay conversion contract. *For additional information, visit www.ins.state.ny.us.* ■

BULLETIN BOARD

√ IRES members who attend the Scottsdale CDS are welcome to attend the Society's Board of Directors meetings. The Board will meet Sunday at 4 pm in the Dunes A-B Room at the Hyatt Regency, and again on Tuesday at 4 pm in Dunes A-B.

√ Many thanks to our friends at the Society of Financial Examiners for the work they did organizing the program on MEWAs at the June meeting of the National Association of Insurance Commissioners in New York City. The session was jointly sponsored by SOFE and IRES and qualified for continuing ed credit.

In the next REGULATOR:

✓ The Scottsdale CDS

✓ A Commissioners Discussion

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Derivatives as time bombs?
STORY P. 1

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