INSURANCE REGULATORY EXAMINERS SOCIETY

IN THIS ISSUE: The Federal Takeover Debate (p. 6)

The NAIC's SVO: Changing duties, changing responsibilities

by Gregory V. Serio
New York State Superintendent of Insurance

To many in the insurance industry, including regulators, the role of the NAIC's Securities Valuation Office (SVO) in this country's regulatory apparatus has always been a bit hazy. Since the organization's responsibilities are now undergoing some profound changes, this would be a good time to provide regulators with an overview of the organization and how it is likely to change in the near future.

The NAIC formed the SVO's predecessor committee in 1907 to develop a consistent valuation of investments reported by insurers on their statutory financial statements. At that time, a committee of regulators and NAIC staff published a manual containing standardized valuations for securities held by the insurance industry.

New York Supt. Serio

In 1942, the volume of investment activity by insurers grew to the point where a separate office for this function was warranted. The NAIC formed the SVO to analyze securities issued by private and public companies and by governmental entities. The idea was to provide uniform credit ratings and/or values for all securities owned by insurers in order to assist state insurance departments in monitoring the financial condition of insurers.

Thus for decades, the SVO's chief responsibilities have been to analyze insurers' portfolio securities, evaluate the credit risk of these securities and establish statement values for these securities. In this role, the SVO assigns various "Designations," ranging from 1 to 6, for the securities they evaluate (Designation 1 being the most financially sound; Designation 6 being the least). Insurance companies report ownership of these securities on Schedule D or DA of the NAIC Financial Statement Blank.

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Secondary guarantees, variable annuities keep regulators on their toes

by Scott Hoober
Special to the Regulator

If insurance regulators do their jobs right, they become almost invisible. Everything goes along smoothly, neither consumers nor companies make many noises and insurance never makes the news (except for what the Legislature might do or not do, but that's another story).

And yet out here in the real world, crises occur pretty regularly.

We're not talking about the problems du jour, such as med mal or workers' comp, but the big, ongoing issues, the ones that cause scads of consumer complaints, the ones where companies fail and the press suddenly discovers the industry as if for the first time. Think Executive Life.

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From the President

Meeting the challenge of regulatory reform

Our March issue of *The Regulator* featured the GAO report on market conduct and the trend toward "market analysis." In this month's issue, Bob Hunter and Thomas Ahart offer extremely interesting and divergent perspectives on Congressman Mike Oxley's vision for state insurance regulation. The following is an update on both these fronts.

With regard to market conduct reform, the NAIC set the stage last fall establishing three significant goals for 2004. In my opinion, these goals are timely and relevant to the reform process.

- ♦ **Market Analysis:** The NAIC envisions that each state will adopt uniform market analysis standards and procedures as well as integrating market analysis with other key market regulatory functions. To accomplish this, each state should appoint a chief market analyst, participate in key NAIC programs, and work collaboratively with the NAIC and other states to produce analysis profiles of nationally significant companies.
- ♦ **Interstate Collaboration:** The Market Analysis Working Group (MAWG) will assist in coordinating cross-jurisdictional issues, reducing the need for duplicate follow-up by different states and reducing the need for routine exams of non-domestic companies.
- ♦ **Uniform Market Conduct Examination Procedures:** Uniform methodology in conducting exams, including uniform data calls, use of ETS, and advance scheduling of examinations. The NAIC also envisions increased coordination of exams with other states.

In February 2004, the National Council of Insurance Legislators (NCOIL) released its newly adopted Market Conduct Surveillance Model Law.

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The purpose of the act is to establish processes and systems for identifying, assessing and prioritizing market conduct problems that have a substantial adverse impact on consumers, policyholders and claimants.

That model relies heavily on the use of Market Analysis and envisions a continuum of market conduct actions. The model also sets uniform protocols for conducting an examination. During the Spring 2004 NAIC meeting in New York City, insurance directors and commissioners decided to place the NCOIL model on the "fast-track" for technical revisions and adoption.

Also during that spring meeting, Congressman Mike Oxley shared his vision of state-based insurance regulatory reform with insurance commissioners.

Congressman Oxley essentially believes the current system needs improvement in several areas, such as speed-to-market, agent licensing, company licensing, market conduct, rate approvals, and coordination among states. He feels consumers currently lack a competitive market and that insurers face increasing competition from other financial services sectors. The House Financial Services Committee envisions a targeted state-based reform based on state participation in key NAIC programs. Some specific goals include:

- Build off of SERFF and a strengthened Interstate Compact to achieve a single-point filing and time-certain review of life insurance, annuity and long-term-care products offered in the U.S.;
- Establish a single point of filing for property and casualty products with expedited review based on clear standards;
- Permit a single choice-of-law option for large multi-state commercial policyholders with limited review for sophisticated commercial policyholders;
- Encourage Illinois-style free-market competition for property and casualty rates;
- Establish full participation in the ALERT process for single point-of-entry for company licensing;
- Achieve full nationwide reciprocal producer licensing;
- Ensure nationwide and uniform adoption of a consensus market conduct law; and
- Create an evenly divided Federal-State insurance coordination council.

The House Financial Services Committee indicated it has shared goals with state regulators and that it will work in close partnership with the State commissioners and NAIC.

No doubt many IRES members will take exception to the reforms advocated in Washington, but I believe we must keep an open mind to change and be prepared to address these challenges as they arise. Keeping informed of the changes and communicating with each other can only improve our current state-based system as well as help us respond positively to calls for reform from the industry and Washington.

IRES, through its seminars, newsletter and network of regulators, will serve an important role in meeting these challenges. The bottom-line challenge, however, remains the same for state regulators—to do our very best in providing effective consumer protection.

Bruce R. Ramge

Bruce Ramge, CIE
IRES President

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Spotlight on corporate governance

What makes a superior board director?

by Warren E. Buffet

True independence — meaning the willingness to challenge a forceful CEO when something is wrong or foolish — is an enormously valuable trait in a director. It is also rare. The place to look for it is among high-grade people whose interests are in line with those of rank-and-file shareholders — *and are in line in a very big way.*

We've made that search at Berkshire. We now have eleven directors and *each* of them, combined with members of their families, owns more than $4 million of Berkshire stock. Moreover, all have held major stakes in Berkshire for many years. In the case of six of the eleven, family ownership amounts to at least hundreds of millions and dates back at least three decades. All eleven directors purchased their holdings in the market . . . we've never passed out options or restricted shares. Charlie* and I love such honest-to-God ownership. After all, who ever washes a rental car?

In addition, director fees at Berkshire are nominal. Thus, the upside from Berkshire for all eleven is proportionately the same as the upside for any Berkshire shareholder. And it always will be.

The downside for Berkshire directors is actually worse than you [i.e., stockholders] because we carry no directors and officers liability insurance. Therefore, if something really catastrophic happens on our director's watch, they are exposed to losses that will far exceed yours.

The bottom line for our directors: you win, they win big; you lose, they lose big. Our approach might be owner-capitalism. We know of no better way to engender true independence. This structure does not guarantee perfect behavior. I've sat on boards and remained silent as questionable proposals were rubber-stamped.

In addition to being independent, directors should have business savvy, a shareholder orientation and a genuine interest in the company. The rarest of these qualities is business savvy – if it is lacking, the other two are of little help. Many people who are smart, articulate and admired have no real understanding of business.

That's no sin; they may shine elsewhere. But they don't belong on corporate boards. Similarly, I would be useless on a medical or scientific board, though I would likely be welcomed by a chairman who wanted to run things his way.

My name would dress up the list of directors, but I wouldn't know enough to critically evaluate proposals. Moreover, to cloak my ignorance, I would keep my mouth shut. In effect, I could be replaced, without loss, by a potted plant.

Last year, as we moved to change our board, I asked for self-nominations from shareholders who believed they had the requisite qualities to be a Berkshire director. Despite the lack of either liability insurance or meaningful compensation, we received more than twenty applications.

Most were good, coming from owner-oriented individuals having family holdings of Berkshire worth well over $1 million. After considering them, Charlie and I — with the concurrence of our incumbent directors — asked four shareholders who did not nominate themselves to join the board: David Gottesman, Charlotte Guyman, Don Keough and Tom Murphy. These four people are all friends of mine and I know their strengths well. They bring an extraordinary amount of business talent to Berkshire's board.

The primary job of our directors is to select my successor, either upon my death or disability, or when I begin to lose my marbles.

At our director's meetings we cover the usual run of housekeeping matters. But the real discussion — both with me in the room and absent — centers on the strengths and weaknesses of the four internal candidates to replace me.

Our board knows that the ultimate scorecard on its performance will be determined by the record of my successor. He or she will need to maintain Berkshire's culture, allocate capital and keep a group of America's best managers happy in their jobs. This isn't the toughest task in the world – the train is already moving at a good clip down the track – and I'm totally comfortable about it being done well by any of the four candidates we have identified. I have more than 99% of my net worth in Berkshire and will be happy to have my wife or foundation continue this concentration. ■

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*Charles T. Munger, Vice Chairman of Berkshire Hathaway

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

Foundation honors Illinois regulator

Mike Hessler (left) with John Mancini

TAMPA — On April 20, Mike Hessler (left) of the Illinois Insurance Department received the IRES Foundation's Paul DeAngelo Teaching Award. It was presented during the Foundation's annual National Insurance School on Market Regulation in Tampa, FL.

The Award is presented to those who make outstanding contributions to insurance education and professional development. Hessler is deputy director of the Illinois Department. He also is a longtime member of the Insurance Regulatory Examiners Society Board of Directors and a nationally regarded expert on the issues of market regulation and market conduct examinations.

The DeAngelo Award was presented to Hessler by John Mancini of the IRES Foundation's Board or Directors. The Award is named after the late Paul L. DeAngelo, who worked for the New Jersey Depatment of Banking and Insurance.

C.E. News

NICE transcripts for the current compliance period Sept. 1,2003 - Sept. 1, 2004 were mailed in May. You will have until Oct. 1, 2004 to submit your NICE Continuing Ed Compliance Reporting form.

On March 15, letters went out to members who had not paid their dues and ran the risk of having their designation suspended. On May 1, these designations were suspended. Contact our office if you wish to reinstate your designation.

What qualifies as CE for NICE?

Qualifying CE includes specific course work and seminars, published articles, and speaking engagements that are 50% or more directly insurance related.

Courses must meet for at least 50 minutes to qualify for one contact hour and 25 minutes to qualify for one-half contact hour. Credit is not granted for less than one-half hour. A maximum of 12 hours will be granted for any individual course or seminar. ONE EXCEPTION: 15 credit hours will be granted for **full** participation in the IRES Annual CDS. Partial credit is available for those who leave early.

Our next CDS will be in Denver. Hope to see you there.

Next compliance period is 9/1/03 - 9/1/04
Reporting deadline is Oct. 1, 2004

Oxley-Baker 'road map' leads in wrong direction

by Robert Hunter

Editor's Note: *House of Representatives Financial Services Committee Chairman Michael Oxley (R-OH) and Representative Richard H. Baker (R-LA), Chair of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, have proposed a plan that would introduce federal oversight into the insurance regulatory process. In this and the article on the facing page, Consumer Advocate Robert Hunter and Thomas Ahart (representing the Independent Insurance Agents & Brokers Association) present their views on this controversial proposal.*

Under Chairman Oxley's "road map," Congress would establish uniform standards for certain aspects of insurance regulation that the states would be required to enforce, "without deviations."[1]

Among the areas that would be preempted is price regulation, which Chairman Oxley termed "deleterious" to consumers, as well as the licensing of insurers and agents. Furthermore, an Interstate Compact would be required to be adopted by all states for some lines of insurance.

Uniform market conduct exams would be required. Certain other model bills proposed by the NAIC and/or NCOIL might be required to be adopted nationwide. Under a "choice of law" requirement, property-casualty policies for large, multi-state companies would only be regulated by the state in which the company is domiciled.

A Federal-State Advisory Council would be created, not to regulate but to coordinate to "see that these reforms are implemented" by all states.

How compliance would be achieved is unclear

What Chairman Oxley calls "intransigent" state legislatures would be cut out of the process. State Insurance Commissioners would become federal functionaries in preempted areas. Chairman Oxley would take this preemptive approach despite his praise for the states as "laboratories for reform" and as "more responsive to the local marketplace as well as to local consumers."

The standards proposed in the road map are startling in their anti-federalist sweep. They do away with decades of deliberations by state legislators, largely eliminating their role in the preempted regulatory areas. This road map would even override the vote of the people of California in adopting Proposition 103 in 1988.

> ***"Why would . . . the elected Commissioner of California choose to enforce inadequate Illionois-style regulatory standards?"***

Chairman Oxley has said that there would be "no federal regulator." But how would Congress force state compliance without the threat of a federal takeover if the states do not comply?

Why would, for example, the elected Commissioner of California choose to enforce inadequate Illinois-style regulatory standards, the very standards that the voters of California rejected in 1988, in lieu of enforcing the overwhelmingly successful Proposition 103 standards that California voters want?

The road map does not say what the "stick" is that will be used by the federal insurance czar to force the commissioners into compliance. Nor does it propose any financial "carrots" to entice a commissioner into enforcing federal standards that would disadvantage constituents.

Price regulation must not be preempted

The road map makes a grievous error in overriding all state price controls on insurance, leaving many insurance consumers vulnerable to predatory pricing and price gouging, while tying the hands of states that want to eliminate these abuses. These vulnerable consumers include small business owners,[2] low and moderate-income consumers and minorities.

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[1] Oxley comments to the NAIC, March 14, 2004

[2] Of the 5.6 million firms in America, 60 percent (3.4 million) have fewer than five employees.

Oxley-Baker offers good ‘road map’ for lawmakers

by Thomas B. Ahart, CPCU, AAI

The Independent Insurance Agents & Bro kers of America (the Big “I”) strongly supports the conceptual approach to insurance regulatory reform developed by Financial Services Committee Chairman Michael Oxley and Rep. Richard Baker, Chairman of that panel’s Insurance Subcommittee.

The Big “I” believes the Oxley-Baker “road map,” which calls for the targeted and focused use of federal legislation to modernize some core areas of state insurance regulation, offers legitimate hope for the first time that enactment of national regulatory reform may be possible for the benefit of consumers.

> *[Oxley-Baker] offers legitimate hope for the first time that national regulatory reform may be possible for the benefit of consumers.*

Enacting federal legislation to address the existing problems with state regulation is not a radical concept. Congress proved that such an approach can work when it passed the National Association of Registered Agents and Brokers (NARAB) provisions of the Gramm-Leach-Bliley Act in 1999, which has led to licensing reciprocity in more than 40 states.

The reasonable approach outlined by Oxley and Baker offers an opportunity to address the problems with the current system, and to enhance the existing insurance regulatory system, without replacing it with federal oversight.

There is widespread consensus among state and federal legislators, regulators, and the insurance marketplace that insurance oversight must be updated and modernized, and that congressional action can quickly bring about reforms that have been sought by state policymakers for years. The states face considerable challenges in enacting consistent statutes in all jurisdictions, and Congress can assist by implementing key reforms nationally.

Congress’s work in this area need not jeopardize or undermine the knowledge, skills and experience that state regulators have developed over decades. While the Big “I” believes such a proposal must modernize those areas where existing requirements or procedures are outdated, it is important to ensure this is done without displacing the components of the current system that work well. The Big “I” believes Congress can, and should, help state policymakers create a more uniform and market-oriented system on a national basis while preserving and strengthening the state regulatory framework. In this way, insurance regulation will continue to be grounded on the proven expertise of state regulators.

Reform road map

In mid-March, Oxley provided his and Baker’s reform vision in a speech before the National Association of Insurance Commissioners (NAIC). At that time, Oxley outlined a conceptual foundation for targeted federal legislation that would address the problems with state insurance regulation identified by Congress over the last three years. The Big “I” strongly endorses the road map’s conceptual approach to reform, and we were pleased to hear Oxley say the committee is not contemplating federal regulation or the creation of an optional federal charter.

The road map outlines a series of policy goals and objectives. Many items included are similar to the Big “I” position on this issue. These goals address the major areas in need of reform—licensing and access to the marketplace, product regulation and review, and market conduct. The Big “I” recommends several reforms to flesh out the framework of the Oxley-Baker road map:

Property-casualty product regulation

The need for “speed-to-market” reform is profound on the property-casualty side of our industry, where insurers are required to obtain formal regulatory approval for products before introducing a new rate or form. Many states currently regulate the development and introduction of new products in ways that cause unnecessary delays, undermine competition and create affordability and availability problems for consumers.

The Big “I” believes Congress should adopt a series of reforms in this area that have four primary

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Oxley — wrong direction

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The kind of deregulation envisioned in the road map assumes that rate regulation and competition are mutually exclusive. They are not. California's auto insurance regulatory system has powerfully demonstrated the utility of maximizing both competition and prior approval of insurance rates for the benefit of consumers.

Chairman Oxley has pointed to Illinois as a regulatory model. There are very few states that have fewer protections for consumers than Illinois. For instance, Illinois does not regulate rates at all.

Since 1989, auto insurance rates have risen by 35 percent in Illinois (versus 30 percent nationally), while California's rates have *fallen* by 8 percent. Prior to adopting the new system voted in by the people of California in Proposition 103, California had the very deregulatory system that the road map now proposes to force on the nation.

"Americans deserve better than 'least common denominator' consumer protection; they deserve the best."

Americans deserve better than "least common denominator" consumer protection; they deserve the best. After intensive study, CFA has determined that the California system of regulation is the best in the nation (see "Why Not the Best?" at www.consumerfed.org). If Congress goes forward with a road map, they should use the nation's best system, not its worst, as its model.

Classifications – Redlining

A critical aspect of rate regulation is the approval of classifications. Some states have moved to ban or limit the use of credit scoring, redlining by territorial definition and control the use of criteria that disadvantage poor people and minorities. All of these types of restrictions would be eliminated by the road map. Insurers would be free to use whatever classes they choose: credit scoring, new territories, human genome information to determine who gets life insurance or Global Positioning System data to track the number of miles policyholders drive and where they go.

Single choice of law

Under the road map, businesses would benefit from a single choice of law. Chairman Oxley stated, "If Microsoft is purchasing liability insurance, the State of Washington would have the greatest interest in protecting the company." If the state of Washington has the greatest interest in pleasing Microsoft, this could often be to the detriment of its residents and consumers across the country. This proposal could provoke state competition to place further restrictions on the legal rights of consumers across the country, as states rush to please large corporations with economic clout that are based in their states.

Improving competition, protecting consumers

Any serious attempt to increase competition in the insurance industry and better protect consumers must take into account the differences that exist between insurance and other products. These differences require that many steps be taken to ensure that free markets function well, including:

- Some degree of imposed uniformity (of insurance forms) is necessary for consumers to understand and compare the complex legal document that is the insurance policy. This allows consumers to shop with the assurance that the products they are comparing are actuarially equivalent. The road map does not require such uniformity.
- Better information about policy prices, the level of service provided by insurers and their financial

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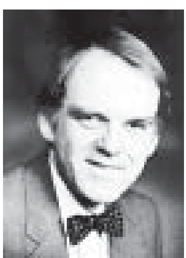

Bob Hunter is Director of Insurance for the Consumer Federation of America (CFA). Before joining CFA, Mr. Hunter was Texas Insurance Commissioner and, prior to that, President of the National Insurance Consumer Organization. He served as federal insurance administrator under presidents Ford and Carter. He is a fellow in the Casualty Actuarial Society and a member of the American Academy of Actuaries.

Oxley — right direction

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effects: (1) make product oversight more market-oriented; (2) provide for the quicker development and introduction of new insurance products; (3) reduce or eliminate unnecessary duplication within and among states; and (4) create greater accountability. Specifically, the Big "I" will work to secure these outcomes with respect to these goals:

- ♦ All states should articulate the standards that apply to the consideration of new policy forms, and all jurisdictions should eliminate so-called "desk-drawer rules" that are not rooted in enacted legislation or properly promulgated regulations.
- ♦ All states should accept filings from insurers via an electronic single point-of-filing system, such as the NAIC's System for Electronic Rate and Form Filing.
- ♦ All states should use a common process for the review of new policy forms (whether for commercial or personal lines products). Under such a system, every state could be required to take action on a newly filed form within 30 days. If the form is not acted upon within that window, it would be deemed approved. If the form is ultimately disapproved, the relevant state regulator would be obligated to clearly and specifically disclose the statutory or regulatory basis for the disapproval.
- ♦ Finally, states should rely on the forces of competition to establish insurance rates, and continue to ensure that all insurance rates are neither discriminatory nor inadequate. Such a model has worked well in Illinois for years and more recently in other jurisdictions.

Life insurance regulation

With regard to life insurance product oversight and consistent with the Oxley-Baker blueprint, the Big "I" supports efforts to ensure the nationwide adoption of the NAIC's interstate compact proposal.

> *"Insurers should not face unnecessary delays and costs when attempting to enter new states."*

Agent-Broker licensing

Although most states have now enacted licensing reform statutes that provide reciprocity to agents and brokers, various burdens and difficulties remain. Several larger states still have not enacted licensing reciprocity, and many states that did pass licensing reform deviated from the NAIC's model law. To enhance and improve the licensing environment facing agents and brokers, the Big "I" urges Congress to consider these licensing reforms:

- ♦ National licensing reciprocity—The Big "I" urges Baker's subcommittee to expand the Gramm-Leach-Bliley Act's reciprocity mandate to all states and establish a nationally reciprocal licensing structure.
- ♦ Licensing uniformity—Additional uniformity is necessary in certain licensing areas, and a targeted federal proposal could help establish greater multi-state licensing consistency for agents and brokers.
- ♦ Countersignature laws and other restrictive barriers—The Big "I" seeks preemption of countersignature laws and similar barriers to effective multi-state commerce.
- ♦ Background checks—The Big "I" also supports the enactment of the background check provisions included in H.R. 1408 as adopted by the House during the last Congress. These protections and safeguards struck the appropriate public policy balance and should be included in any new legislation.

Insurer licensing

Like independent agents and brokers, insurers face challenges obtaining access to new jurisdictions. Consumers are best served by a vibrant marketplace with numerous competitors. As such, insurers should not face unnecessary delays and costs when attempting to enter new states. For this reason, the Big "I" supports a move toward a nationally uniform set of standards or a common process for licensure that would apply in every jurisdiction.

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Oxley-Baker leading in wrong direction

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soundness must be provided to consumers if competition can succeed in spurring lower prices and better quality policies. The road map does not require better consumer information.

- Insurers should be prohibited from misusing classification information. By preempting state rate regulation, the road map will also block state prohibitions on the abusive use of classification information.
- Insurers should be prohibited from "redlining" in certain territorial designations, and other practices that prey upon the poor. By preempting state rate regulation, the road map will block state prohibitions on redlining.
- Insurers should be required to take steps to help consumers afford the purchase of a mandated product. If insurance rates go up, demand does not decrease. Insurance demand is inelastic because states require auto insurance and lending institutions require home and other forms of insurance. If competition is to be fully effective, mandates must be balanced with measures that help consumers to afford insurance coverage, perhaps by requiring limits on underwriting such as mandated offers of insurance to good drivers and to home or business owners who meet building codes requirements. By preempting state rate regulation, the road map will make insurance harder to afford for many small businesses and consumers.

By preempting state rate regulation, the road map will also block state prohibitions on the abusive use of classification information.

Improving uniformity, protecting consumers

CFA has offered a number of proposals that, if implemented nationally, would improve uniformity of regulation *and* protect consumers.

CFA believes implementation of national standards should not be done in a way that stifles state regulatory innovation or that undermines the need for state or regional regulatory variations. After all, there are still many state or regionally based insurers. Insurance risks can vary by region as can specific problems that spur insurance claims.

If consumers in Texas are having problems with mold, Texas regulators should have free rein to place specific requirements on insurers that sell homeowners insurance in their state – including national insurers. This is why CFA supports minimum national standards that would put insurers and consumers on a "level playing field." This would improve uniformity of regulation *and* better protect consumers, while allowing states to exceed minimum standards to meet the specific needs of their residents.

Some of the model bills proposed by NAIC and NCOIL would provide adequate minimum consumer protections at the national level. However, much of this legislation, heavily influenced by insurers, would not protect consumers.

CFA would support the elimination of countersignature laws in the states that still have them, because these rules are vestiges of an earlier noncompetitive era and only protect insurance agents from competition from other, more efficient agents in other states.

CFA would also support deregulation of property-casualty rates for truly large commercial interests, as NAIC and NCOIL have proposed, but only if such deregulation doesn't affect small- and medium-sized businesses that can't afford risk managers to negotiate for them.

Conclusion

CFA has asked the Financial Services Committee *not* to move forward with the ill-advised road map. We have offered to work with the Congress and state regulators on proposals to improve uniformity of regulation and the speed with which insurance products are brought to market — without sacrificing consumer protections. Unfortunately, the current road map does not achieve this balance. ■

Oxley is right direction

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Market Conduct

Both Congress and state policymakers have identified market conduct oversight as one of the aspects of regulation most in need of modernization. The Big "I" suggests that Congress examine the model law recently adopted by the National Conference of Insurance Legislators (NCOIL) and apply it nationally. The NCOIL model would establish a statutory foundation for market conduct oversight activities.

Dispute resolution mechanism

If Congress were to enact a law based on the goals and objectives contained in the recently released road map, the Big "I" recognizes that some mechanism is necessary to address possible disputes. Any structure that is established must not become a backdoor federal regulator. The Big "I" will work with Oxley and Baker to ensure that no federal entity takes on any formal regulatory or licensing power and that the courts retain their final authority to judge disputes that arise under any future act.

Conclusion

The Baker subcommittee's productive and thoughtful work over the last three years has highlighted flaws in state insurance regulation and has showcased the need for timely action. To serve consumers effectively and to compete with other financial services entities, insurance providers must have efficient access to state marketplaces and the ability to develop and introduce products in a timely fashion.

The Oxley-Baker road map offers hope that meaningful reforms can be enacted that address existing inefficiencies, barriers to efficient competition, and the lack of multi-state uniformity. The Big "I" believes the road map's framework is the most effective way to bring about such reforms at the state level and that the use of targeted federal legislation will bring about greater consistency and other needed reforms across state lines. ■

Tom Ahart is chairman of the Big "I" State Government Affairs Committee, a past president of the Big "I," and president of Phillipsburg, N.J.-based Ahart, Frinzi & Smith Insurance.

IRES State Chapter News

Colorado — **Bob Pierce**, Program Director of the Senior Health Insurance Assistance Program, made a presentation regarding the new Medicare prescription drug law for our February training session. In March, we had representatives from Genzyme Genetics talk about the increasing role of genetics in the practice of medicine.
— *Dayle Axman; dayle.axman@dora.state.co.us*

Louisiana — At our March chapter meeting we discussed membership dues, committee assignments and a nominating committee for the election of officers for the coming year. We have invited **Mike Boutwell** of our Company Licensing Division to speak on viaticals and **Sam Brooks** of our Life & Annuities Division to speak on the Life Insurance Contact Database at our next meeting.
— *Larry Hawkins; lhawkins@ldi.state.la.us*

Nebraska — Fred Kottmann, Pam Bishop, Barb Graves and **Kathy Meyer** of Mutual of Omaha presented "How to Reduce Expenses Associated with Market Conduct Examinations" at our February meeting. The presentation included how Mutual of Omaha handles onsite Market Conduct examinations and suggestions on ways carriers can control costs associated with examinations. The presentation also included a look at Mutual of Omaha's electronic inquiry system. Details of future meetings can be found on the IRES Web site.
— *Karen Dyke; kdyke@doi.state.ne.us*

Oregon — In February guest speaker **Kenn Thelen** of the Oregon Workers' Compensation Division discussed how self-insurers set their reserves for claims in order to remain in compliance with Oregon laws. In addition, **Dan Hill** and **Amy Holliday** of the law firm Adams, Day & Hill discussed a person's rights when injured by another party in Oregon.
— *Gary Holliday; Gary.R.Holliday@state.or.us*

Washington, D.C. — At the spring IRES chapter meeting, we discussed recruitment initiatives for 2004 and honored one our staff members for achieving her CPCU and AIE designations. We also discussed the possibility of coordinating regional meetings with our sister states of Maryland and Virginia.
— *Betty Bates; Betty.Bates@dc.gov*

Serio: The NAIC's SVO: changing responsibilities

continued from page 1

Such evaluations are produced solely for the benefit of NAIC members *(i.e.*, states) who use them in monitoring the financial condition of domiciliary insurance companies. Unlike the ratings issued by rating organizations such as Standard & Poor's and Moody's, NAIC designations are not produced to enhance the investment decision-making process, thus they are not suitable for use by any entity other than NAIC members.

Information regarding the securities owned by insurers (including valuations and credit designations) is stored by the SVO in an extensive database known as the Valuation of Securities database. The securities in this database include government, municipal and corporate bonds; common and preferred stocks; and a variety of structured securities. The information in the database is compiled quarterly and is available online to NAIC members through the Automated Valuation Service or by CD-ROM. The SVO also values insurance company investments in subsidiary, controlled and affiliated companies and responds to specific requests from the NAIC's Valuation of Securities Task Force, a group of regulators formed to oversee the operations of the SVO.

Overwhelming

Since its inception, the SVO has seen dramatic growth in the number of securities held by insurance companies. In addition, the types and complexity of the transactions that merit careful review have exploded. With over 225,000 securities on file with the Valuation of Securities database, it became obvious that, barring a substantial increase in SVO staff, it would be unreasonable to expect that all these securities would receive a high degree of scrutiny.

At the same time, various rating agencies and other capital market facilitators such as stock exchanges were duplicating SVO efforts with respect to a large number of offerings. Rating agencies such as Standard & Poor's, Moody's, and Fitch continue to do a credible job of analyzing and evaluating the vast majority of publicly traded securities for the capital market participants that utilize rating agencies for transactions. This is work that insurance regulators should be able to leverage off of.

In the late 1990s, the NAIC adopted the recommendations from its Effectiveness & Efficiency Project, which was initiated to modernize the SVO process. As a result, the NAIC directed the SVO to take the following steps:

- ♦ formulation of a mission statement;
- ♦ establishment of a research unit;
- ♦ reorganization of credit analysis into groups responsible for specific investment types;
- ♦ establishment of an analyst training program;
- ♦ enhancement of the credit analysis process;
- ♦ implementation of a new filing fee system; and
- ♦ exemption from filing of investment-grade securities that are "plain vanilla" in structure.

While these efforts went a long way toward improving operations at the SVO, the sheer number of securities that continued to be filed, along with the information needed to track the issuers of all these securities on an annual basis created a backlog at the SVO.

New York proposals

In 2003, New York proposed, and the NAIC adopted, provisions to exempt from filing requirements — beginning in January 2004 — all securities that had received a rating from a Nationally Rated Statistical Rating Organization (NRSRO). This will exempt from filing and review *more that 85% of securities that were previously filed with the SVO*.

It should be noted that the SVO had acted more as a clearinghouse for the rated securities filed with them, basically just verifying the rating or, in cases where different ratings were issued by multiple agencies for the same security, determining which rating was most appropriate.

A rating organization becomes an NRSRO through application to the Securities & Exchange Commission (SEC). Once a rating organization has been conferred NRSRO status by the SEC, it can request that the SVO include it on their list as an acceptable rating agency and securities that are rated by that rating agency can qualify for the exemption from filing with the SVO.

Currently, the following four firms have received NRSRO designations: Standard & Poor's, Moody's Investor Service, Fitch Rating Service, and, most recently, Dominion Bond Rating Service.

What now?

The question arises: If 85% of the securities previously filed with SVO are now exempt from review, can the SVO provide other services for state regulators with the resources freed up from processing the rated securities? The answer may rest with the concept behind the formation of the New York Insurance Department's Capital Markets Bureau.

In the late 1990s, the New York Insurance Department created the first Capital Markets Bureau within a state insurance department. The Bureau was charged with serving the Department on matters affecting the regulation of capital markets and risk management activities of New York-licensed insurers. The Bureau's responsibilities include, but are not limited to, providing the following services:

- Financial examination support;
- Development of risk-focused exam policies;
- Assistance in developing policy on risk management/capital market issues;
- Analyzing the use of derivatives by insurers;
- Examiner education; and
- Outreach to outside parties.

Having benefited from its own internal Capital Markets Bureau, New York is suggesting that the SVO may be able to focus on many of these same issues, but on a national scope, for those states lacking the resources of a full-fledged capital markets operation.

Currently, the NAIC's Valuation of Securities Task Force is identifying potential SVO functions designed to address the growing impact of capital markets issues on insurance company solvency.

The Task Force will determine SVO's final charge and has indicated it is open to suggestions by other interested parties. Such project proposals will, of course, be subject to resources and staff availability, but these ideas clearly indicate an enhanced role for the SVO in solvency oversight.

In addition to the New York proposals adopted in 2003, the NAIC is exploring alternatives to filing of the securities that are *not* rated by an NRSRO. For example, when an insurer purchases securities its investment process takes into account whether the securities are consistent with the investment guidelines established by its board of directors.

In order to implement the board-established guidelines, company management is charged with developing a process to ensure compliance. These due diligence processes include internal controls and reporting that take into account the credit risk and market risk associated with the investment in addition to other risk measures such as diversification.

If there are "best practices" that can be established and if compliance with these standards can be verified, it is conceivable that insurers that meet such standards could "self-rate and value" these securities. In addition to lightening the load on the SVO staff, these changes could also "raise the bar" by signaling to the industry that there is a regulatory benefit to establishing good risk management practices.

Two other options under consideration are proposals to help reduce valuations for unrated securities by (1) allowing insurers to submit a designated *sample* of such securities for review by the SVO and (2) reducing the number of such securities to be reviewed by the SVO in inverse proportion to the amount of capital held by an insurer.

Conclusion

In summary, the expertise that resides at the SVO is critical to the role of financial solvency oversight by state insurance regulators. While New York has established the aforementioned Capital Markets Bureau, the Bureau has limited resources to monitor the billions of dollars in investments held by the U.S. insurance industry.

Thus, state insurance regulators must rely on the skill sets of SVO staff. It is therefore more important than ever that the resources of the Securities Valuation Office be used as effectively as possible, with maximum input from state regulators. ■

In the summer of 2004, the SVO will be moving from its interim mid-town New York City headquarters (which they've occupied since the collapse of their offices at 7 World Trade Center on September 11). The organization's new headquarters will again be located in downtown Manhattan, at 48 Wall St.

Gregory V. Serio is the Superintendent of the New York State Insurance Department

Guarantees, annuities keep state regulators on their toes

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And, thinking of Executive Life, it seems as if a substantial proportion of those issues surround life insurers.

Jim Poolman, for one, feels it's not just an impression. There really are a whole lot of new, innovative products in the life area.

"This is where we're seeing the most innovation in products, where the products are changing quickly, where they're adding new features and benefits to them," said Poolman, North Dakota's insurance commissioner and a member of NAIC's Life Insurance and Annuities Committee.

Recently, for instance, there have been questions about the adequacy of reserves for the secondary guarantee that many universal life policies now come with. And how about those variable annuities — are they a hybrid of insurance and mutual funds to grab market share, or to drop through the cracks between two sets of regulators?

Adequate reserves?

As Joseph M. Belth points out in a recent article in his respected newsletter, *The Insurance Forum,* premiums for universal life policies with secondary guarantees are lower than normal, and reserves seem inadequate. And worse yet, since life policies generally live on for decades, mistakes made today may not show up for years to come.

We're not talking about the primary guarantee, which is the promise to pay either a death benefit or cash value.

Many universal life policies now come with a secondary guarantee, also known as a no-lapse guarantee (not to be confused with similar guarantees offered in some annuity products during the accumulation phase, before annuitizing, sometimes known as "guaranteed living benefits"). In life policies, the secondary guarantee promises to continue the protection for the life of the insured as long as he or she makes scheduled level premiums — premiums that are well below those for comparable whole-life policies.

As Belth put it in his newsletter, "Marketers, anxious to increase new business and generate large sales commissions, press insurers to issue policies with low premiums. Actuaries figure out how to minimize reserves and justify low premiums. Regulators allow the products to be sold.

"Those individuals will no longer be associated with the life insurance business when the devastating financial consequences of the policies now being foisted on the public will have to be confronted by subsequent generations of marketers, actuaries and regulators."

This problem, if it's true, has a lot in common with a number of previous controversies. As Belth points out, it stems from disagreements between those who are more aggressive and marketing oriented vs. the traditionalists, the conservatives. Between the need to aggressively get into new niches before the competition does vs. the need to unfailingly pay claims when they come due. Or, if you will, between the short-term and the long-term view.

For instance, take the question of whether policies with no-lapse guarantees should be required to offer nonforfeiture benefits.

Insurers that offer a lot of such policies argue that universal life is different from other life products, and that such a requirement would add cost but no benefit. Needless to say, life insurers that don't offer sizable numbers of policies of no-lapse guarantees argue that there should be such a requirement, if only to level the playing field and properly protect consumers.

This latest issue has something else in common with previous ones: the belief that we can safely rely on the regulators. Since life products are regulated stringently, this argument goes, there's nothing to worry about.

As one industry source put it when asked about the adequacy of the reserves on the secondary guarantee: "I think the industry believes that they have proper reserves for the guarantees that are being provided. There are reserve requirements and standards that insurance companies have to follow."

If, for whatever reason, regulation isn't as stringent as it could be, statements like that provide a good cover for unsuitable sales, churning and a host of other sins. With variable annuities, the opportunities to sound sincere but act inappropriately are multiplied, since these products are a cross between an insurance product and a securities product.

Guarantees, annuities keep state regulators on their toes

Through the cracks

Variable annuities, which include a death benefit but whose premiums are for the most part invested in mutual funds, have been growing rapidly over the past few years.

The National Association for Variable Annuities (NAVA) says that the combined net assets of U.S. variable annuities increased 7.7% to $985.3 billion at the end of the fourth quarter of 2004 compared to a year earlier, and net assets increased by 23.7%.

Since many potential investors understand that variable annuities include what amounts to a mutual fund, sales slumped when the equities market dipped. But when the market returned to its base course, so did annuities.

They've never been a terribly good deal for many investors — the death benefit may be as little as premiums paid to date, fees are significantly above the typical mutual fund alone and last year's tax legislation greatly reduces their tax advantage (the bill reduced rates on dividends and long-term capital gains, but didn't extend that reduction to annuities). But the larger question goes directly to the kind of issues with which regulators concern themselves: Are they marketed too broadly, to unsuitable investors? And which regulator, in the end, should be responsible for making these determinations?

"The industry has never contended that they were appropriate for everyone," said Michael DeGeorge, NAVA's general counsel.

"They're appropriate for people who have a long-term savings horizon," DeGeorge continued. "They are not short-term investments, so they are appropriate for those who have a long-term goal, who are looking for tax-deferred growth, who are in some cases looking for guaranteed insurance protection to go along with the growth, such as a death benefit to protect their principal, and also appropriate for those who are interested in creating a lifetime stream of income."

Annuities' fees are structured so that it takes at least 10-12 years for investors to break even and for the annuities to become financially attractive. That fact, combined with steep surrender fees, does indeed make the annuities inappropriate for many people.

With fully 60% of all sales in '03 involving exchanges, there have inevitably been charges of churning and twisting, and some observers say they've seen higher-than-usual rates of arbitration.

DeGeorge says he hasn't seen any evidence of abuse. The product's popularity is simply due to its unique benefits.

"Annuities are really the only product that provides someone with the ability to take that sum of money that's accumulated and convert it into a lifetime stream of income, guaranteed by the insurance company, that will last as long as they live," he said. "A number of studies show that over the long term, variable annuities still are very attractive investments if held for a sufficient period of time."

Belth is one who believes the annuities have been aggressively sold to many Americans who shouldn't be in the market for one.

"I haven't done a specific study, but what I am convinced of is that there is totally inadequate disclosure of the charges and other matters associated with variable annuities," he said in an interview. "That I feel very strongly about.

"There's also a very serious question about suitability for the people who are buying them. But I think it all starts with disclosure rules. They don't disclose the vital information that the buyer needs to evaluate the things."

But just who should be looking at suitability and accuracy of sales materials? For though sales of variable annuities are subject to regulation by the National Association of Securities Dealers (NASD, which recently proposed new suitability regs), in most states the products are regulated by insurance departments. They may call on their brethren in securities regulation for counsel in specific instances, and even refer cases to securities regulators. And several state legislatures have moved to grant one or the other of the two regulatory bodies additional authority.

Yet for all that, some people feel that the annuities tend to fall through the crack between insurance and securities regulation.

Sophisticated buyers

Frank Dino, chief actuary for the Florida Office of Insurance Regulation, feels that dual regulation works fine. After all, federal securities regulators and state

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Regulators tackle secondary guarantees, variable annuities

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insurance regulators are looking at different things.

"The feds aren't looking at reserves, they're looking at disclosure," Dino said. "We don't concentrate on what promises you make on investments, we look at how are you reserving, what is the contract language the person is buying. Even though there's dual regulation and we rely on each other for different aspects, I don't necessarily believe there's any significant overlap or conflict between the two."

North Dakota's Poolman recognizes the risk of dropping the ball into the crack between the two regulators but agrees with Dino that it can work, especially if the NAIC, the feds and the states all push in the same direction.

"If we all work collaboratively together," said Commissioner Poolman, "I think it can be productive and effective."

Are variable annuities aimed too broadly? Are there people who shouldn't be considered for them?

"I'm not sure I'd want to turn around and say that the product should not be available to everyone," says Dino. "The product has some value, it has certain features, and all kinds of consumers need to be given the same opportunity, just so long as they have clear disclosure and there's no misleading or misrepresentation at the time of sale."

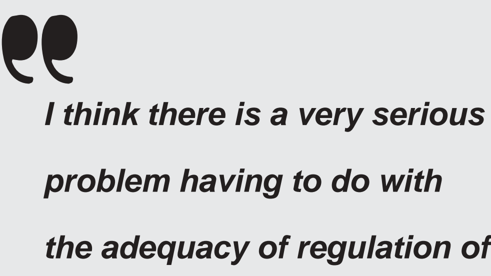
Perhaps that's the crux of the criticism surrounding the product. The mutual fund component makes variable annuities primarily an investment vehicle, while some brokers may be selling them as a form of life insurance.

Belth, though, sees a bigger problem, and it boils down to weak regulation.

"I think there is a very serious problem having to do with the adequacy of regulation of variable annuities," he said. "Part of the inadequacy may be because of the lack of clear jurisdiction."

The rest of the problem, though, is one that involves some of the most basic of regulatory issues: the actuarial assumptions underlying the products, along with disclosure, suitability and the like. It seems as if regulators should have been on top of it from Day One.

"It's very difficult for the regulators to get on top of anything," said Belth, "because of very limited resources and the great skill of the designers of these products to stay ahead of the regulator. The regulators just cannot keep up.



— Joe Belth

"There are several reasons you could say it's not an accident. First of all, the regulators are seriously underfunded, and the insurance industry wants to keep them underfunded. They can't hire the people necessary to regulate adequately. That's part of the plan."

Even if state securities regulators were to take charge, in lieu of insurance regulators, Belth says there's little evidence they're any better equipped to take on the task.

As he points out, many departments don't even have an actuary on staff. It's hard to imagine a department without its own actuaries challenging a company on actuarial issues — particularly when even in-house company actuaries disagree on some of the underlying assumptions.

Whether insurance companies designed variable annuities to be difficult to regulate, or simply to compete effectively in the increasingly competitive financial-services marketplace, the net effect seems to be muddled, slow-moving regulation of such products. What seems to happen is that it takes a few years for regulators to completely catch up with a totally new class of product — and by the time they do, another totally new product is out there, chasing after the same consumers' dollars.

For instance, the NAIC has issued new model suitability regs for variable annuities. But that happened just a few months ago, and few departments have had a chance to implement them.

Regulators tackle secondary guarantees, variable annuities

The regulators' role

The same sort of thing happened with the new reserve requirements that were part of what used to be called Regulation XXX — originally aimed at term life policies, but later extended to the secondary guarantee in universal life. Dino recalls that so many new, related products kept coming out, finally the task force of which he's a member had to add language making clear that the intent of the guideline should apply even in the face of continued change.

"What we were trying to do was say, 'You can't just keep creating ways to circumvent the law.'"

Products that keep pushing the envelope, products that seem almost purposely aimed at skirting regulatory oversight — all that makes it tempting to believe the conspiracy theorists, to assume that sure, the plethora of new life products may be hard to get a handle on, but it's not my fault!

But let's set aside the conspiracy theories. Let's assume that, without question, the diversity of policy design stems purely from the need to compete in the financial-services marketplace. Is insurance regulation up to the task?

After all, the innovation isn't about to slow down. Just last month, the focus was on return-of-premium policies, offered by Fidelity and Guaranty Life Insurance Co. since '01, AIG since '02 and Aegon since March of this year. The policies offer premiums nearly as low as term life (if not lower), plus a savings component like permanent insurance.

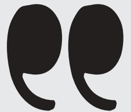
The idea is that, if you hold the policy until it expires (assuming of course that you live that long), you can get back a chunk of cash. But that's a big if, and there are a number of negatives to the concept.

Poolman is willing to admit that the continuing string of successively more complex products, and the accompanying series of separate learning curves, puts hurdles in the path of regulators. But it's up to them to overcome those hurdles.

"As the marketplace changes, so do the needs of how we regulate," he said.

"The last thing I want to do as a regulator is stifle innovation and stifle new products. And yet we also want responsibility in the marketplace, in that the products they offer have a financial solvency about them."

"The important point is that regulators need to make sure that, first of all, they learn the new products, and second of all, that they are flexible in how they regulate." ■



Quote of the Month

" [TRIA] is no longer necessary because the insurance industry is more than able to pay for most terrorism insurance losses in the future. However, if Congress decides to keep some form of back up, it should only target the few areas of the country where getting affordable terrorism coverage might be a problem."

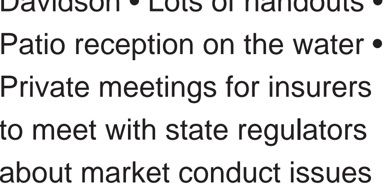
— Travis B. Plunkett, the Consumer Federation of America's Legislative Director, summarizing findings from the organization's recent study on the advisability of renewing the federal Terrorism Risk Insurance Act (TRIA) beyond its 12/31/05 expiration date.

CRAM SESSION

IRES FOUNDATION

Insurers flock to Tampa to learn about latest trends in market conduct regulation

TAMPA, FL. — It was a full house of insurance regulators and industry compliance specialists April 18-20 at the annual National Insurance School on Market Regulation, sponsored by the IRES Foundation. The program, held at the Marriott Waterside in Tampa, included (clockwise from top) • A full-house session on market conduct compliance • Danny Saenz of the Texas DOI • Larry Cluff of the General Accounting Office • Flordia Insurance Director Kevin McCarty • A comic skit starring the NAIC's Eric Nordman and IRES Foundation board member Cindy Davidson • Lots of handouts • Patio reception on the water • Private meetings for insurers to meet with state regulators about market conduct issues



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- ☐ Industry, Non-Sustaining Member $710
- ☐ Spouse/guest meal fee $80

Spouse/Guest name

Hotel Rooms: You must book your hotel room directly with the Denver Marriott City Center. The room rate for IRES attendees is $150 per night for single-double rooms. Call group reservations at 800-228-9290. The IRES convention rate is available until July 15, 2004 and on a space-available basis thereafter. Our room block often is sold out by early June, so guests are advised to call early to book rooms. See the hotel's web site at http://denvermarriott.com.

CANCELLATIONS AND REFUNDS

Your registration fee minus a $25 cancellation fee, can be refunded if we receive written notice before July 15, 2004. No refunds will be given after that date. However, your registration fee may be transferred to another qualifying registrant. Refund checks will be processed after Sept. 1, 2004.

If registering after July 15, add $40.00. No registration is guaranteed until payment is received by IRES.

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

Call for more details: 913-768-4700. Or see IRES web site: www.go-ires.org

√ **James T. Holland**, CFE, CIE, a former Chief Life & Health Examiner with the Michigan Insurance Bureau (and longtime IRES member) reports that as of March 15 he is now Chief Examiner of the Division of Banking and Insurance of the United States Virgin Islands. Since 1997 Jim had worked as an independent consultant, but yearned to return to public service. He wants IRES members to know he plans to "complete his legacy" as a regulator in the U.S. Virgin Islands. Good luck, Jim, on a challenging assignment!

√ Don't delay in booking your hotel room at the Denver Marriott for the 2004 Career Development Seminar. Our room block always fills up fast!

√ Insurance Examiners/Sarbanes-Oxley (Minnesota) — American Express Tax and Business Services seeks insurance examiners for financial examination and Sarbanes-Oxley consulting work. The position is based in MN with 25-50% travel. Bachelors degree, 2 to 5+ years financial examination/insurance industry/accounting experience, AFE/CFE/CIE or CPA required. To apply please visit www.americanexpress.com/jobs. Search using keywords "Insurance," state "Minnesota" and job/function "Accounting/Consulting," and apply for the Insurance Manager (MN) or Insurance Senior (MN) job postings.

In the next REGULATOR:

✓ **What every market conduct examiner should know about financial regulation**

√ Due to space limitations, there is no **Regulatory Roundup** legal report in this issue. This feature will return in the July newsletter.

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The Oxley-Baker Debate.
See stories, p. 6