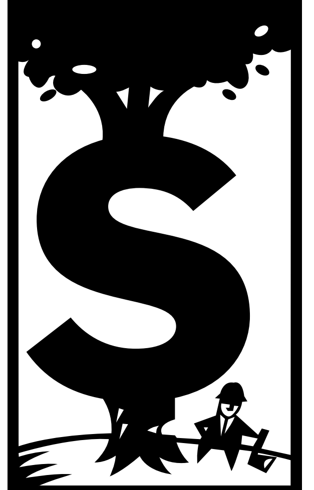
CAPCOs (with help from insurers) pluck the state money tree — often without delivering promised job growth

by Scott Hoober
Special to The Regulator

There are vehicles in the marketplace that allow insurers to receive hundreds of millions in tax breaks and are — in many cases — overseen by state insurance departments, yet few regulators are aware of their existence. The vehicles are CAPCOs (short for certified capital companies) and were authorized by various state legislatures to create jobs in much the same way venture capital (VC) firms do.



A typical VC firm pools money from pension funds, insurance companies, foundations and wealthy individuals, all of whom become limited partners in a fund. The general partners who run the VC firm then invest assets from that fund in startup companies in exchange for an equity stake in the businesses.

Occasionally this kind of early-stage investing hits it big, earning limited partners large returns on their investments. If all goes well, an investor who gives $100 million to a VC firm can expect to get his or her $100 million back, plus a share of 80% of the fund's profits. The venture capitalists — the general partners — take 20% of the profits, plus an annual management fee of about 2.5%, or $2.5 million a year in a $100 million fund.

High risk, high reward — makes sense if you've got the cash to invest.

What if you could make it an even better deal, though? What if you could find someone naive enough to take on just about all the risk — but in return, demand none of the upside potential? And, on top of that, someone who'd let you make a fantastic return even if investments go south, and if things go well, allow you a fee 10 times that earned by a VC firm?

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Sidecars seen as new source of capital

by Shanique Hall

In the aftermath of the 2004–2005 hurricane seasons, demand for disaster coverage has far outstripped supply. The depth of this shortage has created a need for alternative capital. The shortage is particularly acute in the reinsurance sector. Consequently, a number of reinsurers have made use of sidecars in an effort to increase their available catastrophe insurance capacity and bring quick capital to the marketplace. *Regulators should be aware of sidecars because they are expected to become increasingly important to the business strategy of insurers and reinsurers.*

Sidecars are a byproduct of recent natural disasters. They provide capital to back coverage for specific risks. Sidecars are designed to be formed relatively quickly to take advantage of a favorable premium environment.[1] Since Hurricane Katrina, investors have poured about $4 billion into sidecars (as of early October 2006).

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The Regulator

Wayne Cotter, CIE, Editor
quepasa1@optonline.net
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PUBLICATION COMMITTEE: Wanda M. LaPrath, Chair • Kathleen McQueen • Christel Szczesniak • Thomas Ballard • Gerald Milsky • Gary Boose • Janet Glover • Mary Darby • Bruce Ramge • Kashyap Saraiya • David Langenbacher

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e-mail: ireshq@swbell.net

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12710 S. Pflumm Rd., Suite 200 Olathe, KS 66062
913-768-4700 FAX 913-768-4900
IRES Continuing Education Line: 913-768-NICE

David V. Chartrand, executive secretary
Susan Morrison, office manager and continuing ed coordinator

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Legal Counsel: William C. Jolley, LATHROP & GAGE, L.C.

From the President

Budgeting for 2007 — and beyond

I hope everyone had a Happy Holiday season and a good start to a Happy New Year. As IRES carries out its "Winds of Change" by building "Bridges to Tomorrow – The Next 20 Years" and as we plan our finances for 2007 and beyond, it is important to develop structures and funding mechanisms within and outside of IRES in order to implement the long-term changes our Society envisions.

In order to meet our first goal to increase membership and revenue, IRES must provide more tangible benefits. Our Membership and Benefits Committee chaired by Jo LeDuc – and its six subcommittees – are hard at work doing just that. Membership campaigns, State Chapter meetings, new membership categories (individual and firm sustaining members and a new student membership) are some of the developments in process for 2007 (see related story on page 14).

In order to supplement our Accredited Insurance Examiner (AIE) and Certified Insurance Examiner (CIE) designations and provide continuing education benefits for IRES regulatory and insurance industry members, IRES is proceeding with its Market Conduct Certification (MC+) Program, which is another top goal for 2007.

Led by Gary Domer and Kate Bergan, with the assistance of scores of IRES and IRES Foundation volunteers, MC+ is entering its second phase. MC+ is an IRES educational project to provide hands-on training for IRES members on how to efficiently and effectively run market conduct examinations.

Phase One included detailed research and drafting of a course outline and textbook containing 24 chapters and over 700 pages covering all aspects of how to run a market conduct examination.

Phase Two of the MC+ Program includes reviewing the 24 chapters and 700 pages drafted by IRES members and volunteers to ensure style and substance continuity and professional textbook standards.

Phase Three of the MC+ Program most likely will be a two-day training session followed by a multiple choice examination. Plans for regional MC+ site opportunities are being discussed (see story on MC+ in the November 2006 issue of *The Regulator*, p. 16).

A third top goal is a revitalized and rejuvenated Career Development Seminar (CDS), which will take place in Pittsburgh from Sunday, August 12 to Tuesday, August 14, 2007. IRES will also be celebrating its 20th Anniversary. Mike Hessler, Steve Martuscello, and Dennis Shoop are leading a great group of Section Chairs, IRES Education Committee members, and other volunteers to put together a fabulous, entertaining, and educational conference.

All of these top goals and IRES' many other activities require funding. Thanks to IRES Treasurer Karen Dyke and the Finance and Budget Committee for all their hard work in putting together the 2007 IRES Budget. (A link to the IRES Budget for calendar year 2007 can be found on the IRES Web site.)

In building bridges to other organizations, IRES is fortunate to provide and receive cooperation from various entities, including the Association of Insurance Compliance Professionals (AICP), the IRES Foundation, SOFE, and the NAIC.

IRES looks forward to continuing to work with these and other organizations to pool resources to promote the most effective, efficient, and professional regulatory environment possible in 2007 and beyond.

As always, please call me at 636-236-9642 with any questions or comments.

Thanks and take care,

Douglas A. Freeman, CIE
IRES President

Battle of the Press Releases

As Democratic minority leaders in the U.S. House and Senate prepared their transition to leadership roles, the Optional Federal Charter Coalition (OFCC) issued an announcement in early December reminding lawmakers that the Coalition remains steadfast in its opposition to a state-based insurance regulatory system.

The organization once again urged legislators to establish a uniform, national regulatory system. The OFCC is comprised of nine trade associations, including the American Council of Life Insurers, the American Bankers Association and the American Insurance Association.

The announcement followed comments by Rep. Barney Frank (D-Mass), the incoming Chairman of the House Financial Services Committee, expressing skepticism regarding any proposals that would permit the federal government to oversee property/casualty regulation (see Quote of the Month, p. 12).

Meanwhile, the Professional Insurance Agents (PIA) issued a statement noting their long-standing "opposition to optional federal charters and federal regulation of insurance."

Not to be outdone, the Independent Insurance Agents of America's Senior Vice President for Government Affairs, Charles Symington Jr., said:

> Our members can be assured that we will work closely with friends and allies in the marketplace to ward off the creation of a new, unnecessary and inefficient federal bureaucracy, and that we will support real, substantive reform to the existing regulatory system that will fix what's broken and leave what works in place. ■

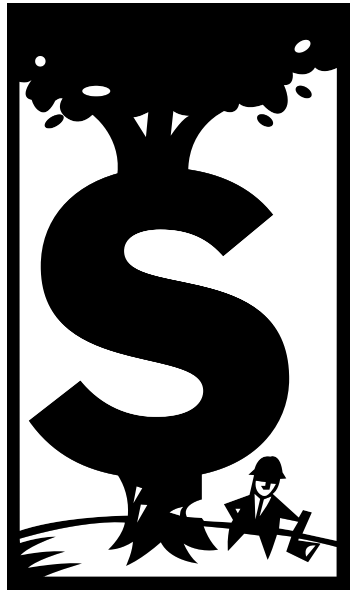
CAPCOs

continued from page 1

That's the deal that CAPCOs have been able to make. Who's the sucker? State governments, that's who.

There's nothing new in states spending taxpayers' dollars to attract economic development. Many state governments have long identified out-of-state businesses and tried to encourage them to move, bringing employees, tax payments and other benefits to the local economy.

What's new is using tax credits to attract investors — and nurture home-grown ones — either through existing VC firms or through certified capital companies. The 44 states (including DC) responding to a recent survey reported committing a total of $5.8 billion to attract investment.



Funny money

Only nine of those 44 states do the job via CAPCOs: Louisiana, Missouri, Wisconsin, New York, Alabama, Florida, Texas, the District of Columbia and Hawaii. (And in these states, it's often the insurance department that's charged with monitoring the program.) Yet most of the controversy over the issue of economic-development finance comes from the relatively few CAPCO states.

Under the CAPCO model, the process gets started when the state gives one of those certified capital companies a chunk of tax credits, say $100 million, in the form of foregone premium taxes from insurers operating in the state.

The CAPCO goes out and borrows $100 million from an insurer in exchange for its premium tax credits. The CAPCO hangs onto half of the total and puts the other half into an investment instrument, frequently a zero-coupon note, and assigns that note as collateral for the insurer's loan.

Over 10 or 12 years, that zero-coupon note earns interest and grows back to approximately the original principal: in our example, from $50 million back up to $100 million. It's never spent — it's held as an investment, as collateral for the insurance company.

Meanwhile, of the $100 million in tax credits that were given to the CAPCO, 10% a year — in our example, $10 million a year — is given back to the insurance company, in what amounts to its coupon. So the insurance company, though playing the role of the limited partner in a VC fund, is guaranteed both its principal and its interest.

None of this cash has yet gone to an entrepreneur. Half of it's gone to that zero-coupon note, the other half to be invested by the CAPCO according to the statutory rules.

One investment professional, who asked to remain anonymous lest he incur the considerable wrath of the CAPCO industry, put it this way: "The insurance company gets the return on its capital, regardless of how the portfolio performs, so it's a good deal for them. For the capital promoters, it's an exceptionally good deal, since the $50 million that they have left to invest essentially goes to their account.

"The day the people who organize the CAPCO close the deal, they're $50 million wealthier, because all of that money belongs to them."

In a traditional VC structure, whoever invested the money — the state in this case — would own a piece of the assets. When a CAPCO steps in, however, it usually gets to hang onto all the upside potential.

As Daniel Sander of the Canadian Tax Foundation put it in a study of state venture capital funds: "The CAPCO program is the most 'popular' VCF [VC fund] program, in terms of the number of states that have adopted VCF programs; however, it is also the most problematic, in terms of its high cost, poor design and target-inefficiency.

"Unlike any other VCF program, the CAPCO program provides a 100% premium tax credit to insurance company investors. In effect, the government underwrites the entire investment risk."

The state, of course, gets to keep any increased revenue that's generated by the new businesses that the whole process brings into the state.

But Sander says that a 1999 study of the first CAPCO program, in Louisiana, "suggests a positive cost-benefit analysis only if highly favorable assumptions — in my view, unrealistic assumptions — are made."

His report, published by the National Association of Seed and Venture Capital Funds, continues: "If the costs of the CAPCO program exceed the benefits, as is likely the case, then the program makes sense only as a limited-term catalyst to create a self-sustaining venture capital industry.

"However, the CAPCO program does not prompt insurance companies to make true venture capital investments and is unlikely to attract other venture capitalists or motivated entrepreneurs to the state. The significant up-front incentive and guaranteed return to the insurance company investors reduce the pressure on CAPCO fund managers to invest the capital in qualified SMEs [small to medium-size entities] . . . . Simply put, a CAPCO fund manager is not subject to appropriate pressure from the fund's investors to undertake the due diligence or monitoring expected in private sector VCFs.

"Indeed, there is a distinct possibility that CAPCOs crowd out private-sector VCFs."

> "*Unlike any other VCF program, the CAPCO program provides a 100% premium tax credit to insurance company investors. In effect, the government underwrites the entire investment risk.*"

The Oklahoma model

If CAPCOs spend too much and succeed too little, what's a hard-pressed state to do if it wants to promote economic development?

All is not lost. And the white knight riding to the rescue is riding in from the direction of Oklahoma.

Sander is one of the observers who feels the Oklahoma model — one of about six different models and the one adopted by Arkansas, Iowa, Michigan and Ohio— is the way to go. Oklahoma uses tax credits too, but unlike CAPCOs, which are offered incentive tax credits, Oklahoma prefers *contingent* tax credits.

The state provides contingent tax credits to the Oklahoma Capital Investment Board (OCIB). The board then borrows money (from banks, not insurers). If the board's investments yield inadequate returns, then OCIB fills the gap with tax credits.

The banks, under the Oklahoma model, get the same kind of assurances that the insurers do under the CAPCO model — yet taxpayers' funds are only used if there's a shortfall between investment returns and what the state is obligated to pay the banks.

"So our tax credits are used only if they're absolutely needed, and then only to the minimum amount needed," said our anonymous source. "And the state ends up owning all the investment assets.

"If there are profits, the state earns the profits," he added. "And if the program operates successfully, they end up with a large amount of money invested at minimal or no cost to the state."

Rather than spend the state's money, wisely or unwisely, Oklahoma harnesses the private sector for public purposes.

Since the program's inception in 1987, there have been two analyses of its impact, in terms of both economic development and impact on the state's treasury.

The latest study shows close to a billion dollars in economic impact, at a cost to the state of Oklahoma so far of about $12 million. Since the state has been operating the program for about 15 years, Oklahoma is out of pocket under a million dollars a year — for a program that's had nearly a billion dollars in impact to the state.

The Oklahoma program operates through existing VC funds, carefully selecting outfits whose strengths match the state's needs. One professional formerly associated with the state's program estimates they look at about 200 VC firms a year and invest in just a small handful, though only after carefully analyzing who they are, how they do what they do, how they've performed in the past and what their reputation is — for both financial results and ethics.

If, despite all the research and evaluation, the VCs make poor choices, the state could still lose its shirt. But, as with limited partners in a traditional VC setup,

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there is a huge potential upside as well. So far it's been working.

"The strategy is to attract the smartest investors we can find to serve the best investors in Oklahoma," said a former Oklahoma staffer who also asked to remain anonymous. "So we would go all over the country looking for investors who understand the types of investors that are emerging in Oklahoma, and want to be in Oklahoma, and have a plan for serving entrepreneurs in Oklahoma."

CAPCOs, by contrast, are evaluated not on their investment track record, but on how quickly they can line up commitments from insurance companies and allocate the tax credits.

Oklahoma's first VC fund was Ventures Medical, which specialized in bioscience and had experience with commercializing technologies from Houston's Baylor College of Medicine.

Why bioscience? Not because it was trendy and exciting, but because Oklahoma already had untapped resources in that area. OCIB officials noticed that there was a lot of medical and bioscience research in Oklahoma City, but all the new technology was being licensed out of state.

> ***Rather than spend the state's money, wisely or unwisely, Oklahoma harnesses the private sector for public purposes.***

State-by-state detail

In addition to seeking out VC funds that match the state's needs, successful state programs (and VC firms themselves) also look for in-state entrepreneurs likely to derive the most benefit from added capital.

The small businesses most likely to succeed are rapid-growth startups known in the trade as "gazelles," which by some estimates make up only 4-8% of all small businesses but account for 70-75% of new jobs.

Even though **Colorado** was already one of the top ten states in attracting venture capital, its Legislature enacted a CAPCO program in 2001, the sixth state in the nation to do so, after Louisiana, Missouri, Wisconsin, Florida and New York. Legislators made $200 million available in premium tax credits, to be allocated in two tranches (funding rounds) of $100 million apiece.

The state's Division of Insurance was designated to verify that the correct tax credit was taken. The statute didn't provide for documentation of economic benefits, and a 2003 state audit found inconsistencies in employment data provided by the CAPCOs.

When legislators found that $100 million worth of tax credits yielded a pool of only about $40 million for the CAPCOs to invest, they got a little upset.

As the audit put it: "Research indicates that CAPCO Programs are the most inefficient means for a state to raise venture capital. According to one CAPCO researcher, 'the principal problem . . . is the large share of funds (40-60%) that are not available for investing in qualified businesses because they are held in government securities to guarantee the insurance companies' initial investment.'"

The program was extensively revised. One member of the Legislature who voted aye the first time around — Doug Dean, later appointed insurance commissioner and currently heading the Public Utilities Commission — was quoted as saying about his aye vote on the CAPCO legislation: "As a legislator, I passed 80 good bills. And one bad one."

New York has invested premium tax credits via CAPCOs since 1997, with 30 insurers investing between $400,000 and $6 million in the first round. By the fifth round, the number of companies was up to 51. A June 2006 report found an overall increase in employment of 607 in qualified businesses, with 56 businesses losing employees, 7 reporting no change and 54 with increases.

In all, New York's five program rounds were allocated $400 million, or $659,000 per new hire.

Connecticut, Maryland and **Massachusetts** do not rely on CAPCOs, but directly invest public funds in local companies. Others, such as **Pennsylvania** and **Oregon,** ask public pension funds to place a small percentage of their investments with local VC firms.

A number of states, including **Maine, Ohio** and **Virginia,** offer tax credits to wealthy individuals, known as "angel investors," for investing seed money in local startups.

In **Missouri,** which relies on CAPCOs, things looked good after the Innovation Creativity Capital (IC2) Institute of the University of Texas recently issued a report concluding that the state's program was promising in terms of jobs created and investments leveraged.

However, a follow-up report by researchers with the Rural Policy Research Institute's Rural Equity Capital Initiative found that, "Although we do not dispute that the Missouri CAPCO program has provided economic benefits to the state, we have [found that] the magnitude of job creation demonstrated in the IC2 report is subject to question . . . the assumptions underlying the report have not been adequately developed or justified [and] there is no consideration given to the cost to the state of these programs.

"In fact, program cost may be the most relevant public policy issue in evaluating the CAPCO program. That is, could similar economic development benefits be provided by an alternative public venture capital program at less cost to the state treasury?"

> ***"Could similar economic development benefits be provided by an alternative public venture capital program at less cost to the state treasury?"***

Colorado and New York are among the states that favor business development in underserved parts of the state. Colorado called for 25% of investment to be in rural areas, while New York spread out the money across the state, including designated Empire Zones.

However, there's a body of research indicating that favoring rural areas, in particular, is poor public policy. In general, investment should go where existing entrepreneurs want it to go, which for the most part is in urban areas.

The insurance connection

In many states, insurance companies are a big part of the process. That's because the state's contribution — the $100 million in our example — is in the form of a premium tax credit.

If an insurance department were funded from premium taxes, that foregone income could be a real issue. But from a solvency standpoint, the fact that insurers make a loan that converts that credit into cash doesn't seem to be cause for concern. The loan amounts to a fixed-income investment, with no greater-than-usual risk.

There is a question as to whether it makes sense for taxpayers, but let's face it: That's a couple of pay grades above most financial examiners.

No, the real problem comes, ironically, from just how good a deal it is.

At first, insurers were participants in the process only because the CAPCOs came to them and made them an offer. But seeing how well it works for them has converted many companies into extremely willing participants.

"The insurance industry has joined the lobbying team for CAPCOs," said our anonymous source. "It's no longer a matter of 'They offered me a deal so I'm going to take it.' They're now actively participating in some states.

"After all, it is an exceptionally good investment, and once you get something good, you want to keep it. And you'd like more of it."

In most states, the total amount of premium tax credits is oversubscribed by eager insurers.

The effectiveness of the lobbying — funded by financial resources that CAPCOs have received from taxpayers, and abetted by the lack of transparency at every stage — is what gives these folks the opportunity to continue feeding at the public trough (as well as the ability to get people fired and to threaten lawsuits often enough to make our knowledgeable source prefer to remain anonymous).

CAPCOs have also managed for the most part to put a positive public face on their enterprises, and to expand into new jurisdictions.

With virtually every state involved in economic-development finance in some form, however, and with negative publicity about CAPCOs beginning to find its way into the public eye, things are likely to get more and more interesting.

If only because insurance companies are one of the major players in the CAPCO model, this is one issue that regulators will probably want to keep track of in the years to come. ■

What Is the Difference Between IRES and the IRES Foundation?

Did you know that the Insurance Regulatory Examiners Society (IRES) and the IRES Foundation are totally separate organizations?

In July 1987, the National Association of Insurance Commissioners (NAIC) endorsed the formation of an independent "Society of Market Conduct Examiners." The organization has since evolved into IRES, a 501(c)(6) not-for-profit corporation.

IRES membership is open to all insurance regulatory professionals who work in the field as well as in the office. This includes investigators, policy analysts, rate analysts, complaint handlers, financial examiners, market conduct, departmental actuaries and attorneys and other state employees, independent contractors, law firms, insurance companies, associations, and individual industry personnel, lawyers, and other professionals. Among IRES' activities are the annual Career Development Seminar (CDS), the Accredited Insurance Examiner (AIE) and Certified Insurance Examiner (CIE) designation and continuing education program, and a variety of state and national activities that can be found on the IRES web site at **www.go-ires.org.**

The IRES Foundation is a not-for-profit corporation and educational trust pursuant to Section 501(c)(3) of the U.S. Internal Revenue Code and organized under the laws of Missouri. The Foundation's mission is to assist in the development of educational and training opportunities for professional insurance regulators as well as educating the private sector about state insurance regulation. The Foundation funds not-for-profit educational programs and awards grants and seed money to qualifying organizations – like IRES. The IRES Foundation helped with seed money for the IRES continuing education program as well as tuition waivers for eligible IRES members to attend the annual CDS.

The IRES Foundation each spring sponsors The National Insurance School on Market Regulation, which brings experienced state insurance regulators together with insurance industry personnel to review the latest issues governing "market conduct" and market regulation compliance. More information can be found at **www.ires-foundation.org**.

The IRES Foundation operates independently of IRES, yet works closely with IRES to develop educational programs. Several IRES officers are members of the Foundation's Board of Directors.

The work of IRES and the IRES Foundation ultimately benefits all those involved or affected by insurance regulation. Well-trained and well-equipped regulators do a better job of protecting the public and monitoring the insurance marketplace. Regulators who continue their education are better positioned to regulate and communicate with the insurance industry, resulting in a clearer understanding of regulatory requirements and expectations, and more cost effective examinations.

To that end, the IRES Foundation created an endowment to raise funds for that purpose. Below are contributors to the IRES Foundation Endowment Fund during 2006.

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It's not the service contract. It's the claim: 'We're Insured'

By Arthur J. Chartrand

Commentary

Although the adoption by the Virginia Legislature of HB 383 (see below) eliminated the definition as insurance for home service contracts, the law did nothing to prevent a few thinly run service contract schemes from gaining ground on the claim that they are safe and solvent simply because they are insured.

The failure of the automobile warranty plan by the National Warranty Insurance Company (NWI) of Lincoln, Nebraska and the Cayman Islands several years ago has confused many regulators and legislators just as the 1990 demise of the Home Owners Warranty Corporation (HOW) caused the state and many consumers a great deal of grief when it failed in 1990. (HOW was not a service contract company *per se,* but a home builder warranty program that operated more like a surety insurer. It was the failure of the HOW's insurance company, a risk retention group, that ultimately led to its collapse.)

Those who failed to understand the root causes of the NWI and HOW insolvencies took aim at the service contract and warranty programs. The real problem was the promoters of these now-defunct companies and their crafty utilization of substandard insurance operations to back their operations.

Cases like HOW and NWI were enabled because the operators of the programs could boast, "Don't worry about us or our finances, it's all backed by insurance." Both failures had ties to closely controlled insurance operations. Like many insurance failures, the paperwork was all in order. The problem was there was no real money in reserve when the scheme failed.

The reality is that the NWI and HOW fiascos were brought about by the failure of an *authorized insurance company* that purportedly backed the product. The overreaction by some states to push more regulation for noninsured service contract firms is difficult to follow logically.

Political cover does not always follow logic. In some cases the reaction was inexplicable. Vermont reacted by requiring that *all* service contract providers be backed by insurance. This is akin to addressing the problem of a rash of dog-bite cases by requiring all homeowners to own a dog.

The lesson of NWI may come back to haunt states that continue to allow credit for offshore reinsurance. There is mounting evidence that some emerging global firms are promoting other forms of warranties on the same NWI model.

Any program that acquires a legitimate fronting insurance company but claims full reinsurance — or by a captive insurer, based in such places as the Turks & Caicos Islands — needs to be closely examined. It may look fine on paper. But then, so did all the big insurance failures of recent history.

But anyone who paid attention to the NWI or HOW cases must ask, "Where's the real money*?* I mean *really*?"

Arthur Chartrand is a Kansas City attorney and national regulatory counsel for the National Home Service Contract Association.

Last spring — after years of debate — the Virginia Legislature, with the support of the Virginia Department of Insurance, passed HB 383. The bill, as signed by the Governor, stipulates that home service contracts are not insurance in Virginia.

Under HB 383, effective July 1, 2006, the Virginia Department of Insurance will continue as the regulatory agency for *home* service contracts while *retail* service contracts remain regulated under the Virginia Department of Agriculture and Consumer Affairs.

Retail service contracts generally cover new consumer goods and are provided by the manufacturer or seller, while home service contracts are annual service agreements on a package of existing home appliances and systems. A full explanation on home service contracts can be found at **www.homeservicecontract.org**.

The National Home Service Contract Association (NHSCA) remains concerned that regulation under any state insurance department may send an erroneous message to consumers that there is some insurance aspect to their contracts. However, the NHSCA supported HB 383 as a major step forward, despite provisions in the bill retaining insurance type measures to monitor service contract providers.

This means all 50 states now treat home service contracts as outside the business of insurance. Several states regulate other types of service contracts (automobile and retail) under various insurance laws or regulations.

— *AJC*

Alternative source of capital: sidecars

continued from page 1

According to reinsurance officials, 2006 mid-year reinsurance renewals were dramatically bifurcated, with property coverage expensive or difficult to obtain. Officials cite problems securing catastrophe reinsurance for Florida, elsewhere along the U.S. Gulf Coast, as well as the Northeast. The situation was more difficult than during previous hard hit markets (*e.g.*, Hurricane Andrew and September 11) when there was ample supply if the price was right.

Disaster-insurance rates have risen so sharply that businesses with exposure to hurricanes are canceling projects, paying more for whatever coverage they can get, or going without insurance altogether, according to *The Wall Street Journal*. In one such example, early last year the First Reserve Corporation, a private equity fund, wanted to buy an oil-and-gas platform in the Gulf of Mexico. During a conference call, the fund's executives learned that insuring the project would cost about $25 million a year, not the $2 million they had expected. The firm decided to cancel the deal.

Today, there is a distinct lack of capacity regardless of price. To fill the void, investors have begun pouring billions into sidecars. Sidecars offer a simple but versatile alternative to the traditional reinsurance marketplace.

What are Sidecars?

Sidecars are special purpose vehicles that are established to assume underwriting risk from ceding insurers or reinsurers. The reinsurer shares some of the risk (underwriting losses and related expenses) and takes some of the premiums earned by the vehicles through a multi-year quota-share reinsurance contract (they take a portion of the reinsurer's business by way of the quota-share contract). The sidecar has no staff of its own, the reinsurer that sets it up does all of the underwriting for a fee.

In its simplest form, a sidecar is a new reinsurer sponsored by an established reinsurer, with most of the capital coming from third-party investors. A typical sidecar structure comprises a newly created licensed reinsurance company that assumes risks, collects premiums from, and pays claim losses to, the ceding insurer or reinsurer via a quota-share reinsurance agreement.

The sidecar is capitalized via equity and debt financing as a newly created holding company provided by private equity investors (*e.g.*, usually hedge funds and other institutional investors). Proceeds from the securities offerings, as well as premium and investment income, are then customarily transferred to a Collateral Trust, which invests the proceeds and disburses funds to the ceding insurer or reinsurer on behalf of the new reinsurer to pay claims. Funds are also disbursed to the holding company, via the new reinsurer, to pay interest on debt and dividends, if any, to shareholders.[2]

For the reinsurance company, the primary use for sidecars is that the reinsurer can write more business than it could have written without having to raise more capital. The reinsurer does not have to increase its level of long-term debt or undertake a dilutive equity offering.[3]

Sidecars differ from typical reinsurers in that they include: (1) private equity vs. publicly traded shares, (2) a defined risk period and a finite lifetime, (3) a highly structured limited-purpose nature, (4) defined risks, (5) a business relationship typically limited to a single reinsurance cedent or contract and (6) no active staff.[4]

For third-party investors (hedge funds and institutional investors) sidecars are a relatively easy way to enter the insurance business. In addition, they offer higher-yielding instruments that are linked to clearly defined risk categories rather than the credit of the entity. For a sponsoring reinsurer, a sidecar moves risk off the balance sheet and brings access to capital necessary to increase capacity, fulfilling client needs and diversifying the revenue stream.

Sidecars are generally described as "sophisticated retrocessionaires" — a way for the new reinsurance company to provide reinsurance (by transferring portions of reinsurance risk to secondary reinsurers). Some sidecars operate like traditional reinsurers and others operate as fully collateralized retrocessionaires. Often, the sponsoring reinsurer provides both options to investors, and offers both rated paper through one entity and non-rated, but collateralized paper, through another entity at different prices. However, all sidecars are dependent on the parent for underwriting expertise.[5]

In December 2005, Standard & Poor's rated its first sidecar deal (see sidebar). To date, Moody's has

assigned ratings to four reinsurance sidecars. Moreover, four sidecar arrangements have been established recently in Bermuda and the Cayman Islands and Moody's expects additional sidecars will form over the next six months. Moody's notes other sidecar-like structures have recently been established and have been well received by insurers and reinsurers.

Sidecars are not an entirely new innovation. According to an analyst at Fitch Ratings, "the prevalence of the sidecars that have come out recently is to provide capacity . . . which is probably more constrained recently than it has been in recent years, and sidecars are a good way to provide that capacity." The pace of growth in the sidecar market has been very swift.

Risks

Sidecars are not without risk. In a benign hurricane season, sidecar returns could be as high as 30% (investors get their money back plus premiums paid by policyholders).[6] However, if a hurricane season mimics 2005, investors can lose their entire capital.

In 2005, Olympus Reinsurance Co. Ltd., a Bermuda based sidecar, saw $650 million in capital wiped out when the insurer it was linked to, White Mountains Insurance Group Ltd., experienced heavy storm losses.

Summary

Sidecars were very much a phenomenon of 2006 fueled by the lingering effects of the 2005 hurricane season. They represent an innovative capital and risk management structure and are likely to become increasingly important to insurers and reinsurers alike. To date, the impact of sidecars on the reinsurance market has been relatively modest.

Although sidecars' long-term prospects once the reinsurance market softens are unclear, Moody's predicts continued growth and development in the nascent sidecar market. ■

Shanique Hall is a Research Analyst III for the National Association of Insurance Commissioners' Securities Valuation Office (SVO). The above is an abridged version of an article that appeared in the September 2006 issue of the SVO's *Research Quarterly*.

Endnotes

[1] Child, Carey, "Inside the Reinsurance Sidecar," Business Briefing, 7/27/06.
[2] Moody's Investors Services, "Reinsurance Side-Cars: Going Along for the Ride," 4/25/06.
[3] Child, Carey, "Inside the Reinsurance Sidecar," Business Briefing, 7/27/06.
[4] Moody's Investors Services, "Reinsurance Side-Cars: Going Along for the Ride," 4/25/06.
[5] "New Ventures, New Vehicles," Best Review, 5/1/06.
[6] Zuill, Lilla, "Insurance Sidecar Investors on White-Knuckle Ride," Reuters, 7/11/06.

First Sidecar Rated By S&P

On Dec. 29, 2005, Standard & Poor's Ratings Services assigned its 'BBB-' counterparty credit rating to Flatiron Re Ltd. and its 'BB+' senior secured debt rating to Flatiron Re's $256 million term loan facility. Flatiron Re is a limited-life, special-purpose Class 3 sidecar domiciled in Bermuda and set up to offer reinsurance to Arch Reinsurance Ltd.

The Flatiron Re ratings are based on peril modeling supportive of investment-grade outcomes, Arch Re's brief but solid track record in managing property catastrophe risk, and Flatiron Re's risk tolerances.

These positive factors are offset in part by (1) the fact that the company can neither refuse business from Arch Re nor change the underwriting arrangement, (2) its high financial leverage, and (3) the structural subordination of the bank debt relative to policyholder claims. Flatiron Re may borrow up to $520 million from a consortium of banks for a term of at most five years, receive equal amounts of equity from investors in its parent holding company, and invest most of the proceeds in a portfolio of investment-grade securities within a collateral trust account.

The assets in the collateral account provide Arch Re with a source of indemnity cover for losses relating to its property catastrophe lines of business and other related lines. Arch Re will make quarterly premium payments to Flatiron Re through a quota share reinsurance treaty.

Source: Standard & Poor's

“ Quote of the Month ”

“Life insurance has increasingly become a financial product, and geography is not nearly as important in life insurance as it is in property/casualty. I’m very skeptical of the argument for nationalizing property-casualty insurance [regulation].”

— Rep. Barney Frank (D-MA), incoming Chairman of the House Financial Services Committee

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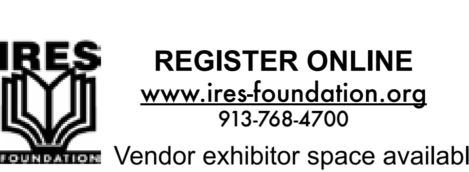

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Plan to stay over for a Carolina Clambake Tuesday Nite

IRES State Chapter News

COLORADO — In October, **Tom Abel**, Supervisor of the Division's Producer Licensing and Rates and Forms section, conducted a presentation on insurance ethics. We also had training regarding Colorado's Open Records Act from **Roxane Baca** of the Attorney General's office.
In November, **Jim Carr** of the Attorney General's office provided training on rulemaking. In addition, we had a presentation by **Brad Stolz** and **Matt Blackmer** of Professional Investigative Engineers regarding the use of automotive event data recorders in the investigation of automobile accidents.
— Dayle Axman; Dayle.Axman@dora.state.co.us

LOUISIANA — The Louisiana Chapter meeting was held on October 19. **Mike Boutwell**, Assistant Director of Licensing/ Company Licensing Division, discussed Viatical Settlements and their history. There were 12 members in attendance.
Our Chapter held an Officers'/Committee meeting on November 9 to discuss our membership drive.
—Larry Hawkins; lhawkins@ldi.state.la.us

NEBRASKA — **Tim Wagner**, Director of the Nebraska Department of Insurance, spoke at our October chapter meeting. Tim discussed global warming and climate changes and their effect on the insurance industry.
Details of upcoming meetings can be found on the IRES Web site, as they are scheduled.
—Karen Dyke; kdyke@doi.state.ne.us

OREGON — Our October meeting featured **Jonnie Massey** of Regence BlueCross BlueShield who presented an interesting 90-minute session on the company's program for dealing with health care fraud, abuse and scams.
At our November meeting, Division Administrator **Joel Ario** discussed the new NAIC Insurance Regulator Professional Designation Program. Also, the group heard from **Teri Glocar** of the State Fire Marshal's office concerning proposed legislation that would require all cigarettes sold in Oregon to be self-extinguishing. This issue is of interest to the insurance community because of the number of cigarette-caused fires that result in injuries, loss of lives and substantial property damage losses.
—Cliff Nolen; Cliff.Nolen@state.or.us

If you have state chapter news, send it to Larry Hawkins at ***lhawkins@ldi.state.la.us***

Welcome, new IRES members

Paula Pinelli, California
Melissa Hull, Ohio

Celebrate 20 years by saving $20

Happy 20th Anniversary IRES! To celebrate, IRES is offering anyone who qualifies for general membership and has not been a member in the last 12 months the opportunity to become a general member for only $55 – a savings of $20 off the first year's membership dues. New members will receive all of the benefits and services IRES has to offer and opportunities for local chapter participation. Don't wait — join today! This one time very limited offer is only good during the 3rd annual membership drive and must be acted on by March 1, 2007. To learn more about what IRES has to offer, visit us on the Web at **www.go-ires.org.**

But that's not all. Current IRES members can also join the celebration by recruiting new general members! Every current IRES member who recruits at least one new general member will receive a token of appreciation from IRES. The more new general members you recruit, the bigger your reward.

Number of General Members Recruited	**Reward**
1	Token of Appreciation
2	$25 American Express Gift Card
3	$50 American Express Gift Card
4	$75 American Express Gift Card
5 or more	$100 American Express Gift Card

You will find everything you need to promote IRES on our Web site.

For full details of this year's membership drive, refer to the Campaign Details below.

For additional information about this year's membership drive, contact IRES at **ireshq@swbell.net** or 913-468-4700. You may also contact Jo A. LeDuc, Membership & Benefits Chair, at **jo.leduc@oci.state.wi.us** or (608) 267-9708.

Campaign Details:

- Campaign Dates: December 15, 2006 through March 1, 2007.
- To qualify for the discounted membership dues, new general membership applications must be postmarked on or after December 15, 2006 and on or before March 1, 2007.
- A new general member is an individual who has never joined IRES before or a former member whose membership has lapsed for more than 12 months *and* at least 75% of his/her professional time is spent working on behalf of a state or federal insurance regulatory agency.
- No refund for new membership dues paid prior to December 15, 2006 will be given.
- Discounted membership dues are valid only for the first year's dues. Subsequent renewal dues will be the current membership dues level based on the individual's membership category.
- For existing IRES members to receive credit for the referral, new general membership applications must be postmarked on or after December 15, 2006 and on or before March 1, 2007 and the referring member's name *must* appear on the application prior to its being received by IRES.

Special 20th Anniversary Application for New General Membership

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Annual dues for new general members (without a designation who have not been a member during the last 12 months) **where the application is postmarked on or after December 15, 2006 and on or before March 1, 2007 are $55.00.** Annual dues for non-new general members or for new general members with applications postmarked outside the above time frame are $75.00.

Checks payable to Insurance Regulatory Examiners Society should accompany each application.

I hereby certify that I am currently involved in the regulation of insurance company operations or products with the above named agency, *and* that at least 75% of my professional time is spent working for or on behalf of a state or federal insurance regulatory agency.

Signature Date

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General Membership is open to:

- **Salaried government regulators:** Any person employed by or employed on a salaried basis with a state/federal insurance regulatory agency, provided said person's responsibilities include regulatory examination of insurance company products, performance of contracts with policyholders, finances and operations, either in the insurer's or the agency's offices. This includes investigators, policy analysts, rate analysts, complaint handlers, financial examiners, market conduct field examiners, producer licensing examiners, departmental actuaries and attorneys and other professionals engaged in insurance regulation.
- **Contract regulators:** A regulator employed under contract or appointment by a state/federal regulatory agency, as defined in the Society's bylaws, provided such employment represents at least 75% of the examiner's work. Each applicant for IRES membership must designate a primary state for which the applicant does regulatory work, even if the applicant is an independent examiner whose work assignments change regularly.

NOTE: Former general members that held an AIE or CIE designation wishing to re-join IRES and have their designation reinstated should apply for membership using the standard membership application found on the IRES website. Questions regarding the dues and requirements regarding compliance with the current mandatory continuing education requirements in order to reinstate the designation should be directed to the IRES office at 913-768-NICE (6423).

Regulatory Roundup

by
Stroock & Stroock & Lavan LLP

UNITED STATES – Nonadmitted and Reinsurance Reform Act of 2006 is introduced in the United States Senate

On November 13, H.R. 5637, a Bill that was passed by the U.S. House of Representatives on September 27 entitled the "Non-Admitted and Reinsurance Reform Act of 2006", was introduced in the United States Senate and referred to the Committee on Banking, Housing, and Urban Affairs.

The Bill, among other things, establishes national standards for (i) reporting, payment, and allocation of premium taxes, (ii) regulation of nonadmitted insurance (*i.e.*, surplus lines) by an insured's home state, (iii) surplus lines eligibility, and (iv) regulation of credit for reinsurance and reinsurance agreements. The Bill prohibits any state, other than the home state of an insured, from requiring a premium tax payment for the purchase by an insured of nonadmitted insurance and authorizes states to enter into a compact or otherwise establish procedures to allocate among them the premium taxes paid to an insured's home state. Section 102 of the Bill provides that only an insured's home state may (i) require a surplus lines broker to be licensed to sell, solicit, or negotiate nonadmitted insurance with respect to such insured, or (ii) enforce regulations governing nonadmitted insurance.

Any state law or regulation that applies to surplus lines insurance sold to, solicited by, or negotiated with an insured whose home state is another state is preempted under the Bill. In addition, after the expiration of the two-year period beginning on the date of the enactment of the Bill, a state may not collect any fees relating to licensing of an individual or entity as a surplus lines broker unless the state has in effect at such time laws or regulations that provide for participation by the state in the national insurance producer database of the NAIC. Section 104 of the Bill provides that a state may not prohibit a surplus lines broker from placing nonadmitted insurance with a nonadmitted insurer domiciled outside the United States that is listed on the "Quarterly Listing of Alien Insurers" maintained by the International Insurers Department of the NAIC.

Furthermore, with respect to an exempt commercial purchaser, a surplus lines broker seeking to procure insurance for such purchaser is not required to satisfy any state requirement to make a due diligence search to determine whether the amount or type of insurance sought can be obtained from an admitted insurer provided that the broker (i) discloses to the exempt commercial purchaser that such insurance may or may not be available from the admitted market that may provide greater protection with more regulatory oversight, and (ii) the exempt commercial purchaser has subsequently requested in writing that the broker procure or place such insurance from a nonadmitted insurer.

The Bill also provides that if the state of domicile of a ceding insurer is an NAIC-accredited state, or has financial solvency requirements substantially similar to the requirements necessary for NAIC accreditation, and recognizes credit for reinsurance for the insurer's ceded risk, then no other state may deny such credit for reinsurance. If the state of domicile of a reinsurer is an NAIC-accredited State or

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The New York-based Stroock & Stroock & Lavan LLP Insurance Practice Group includes Donald D. Gabay, Martin Minkowitz, William D. Latza and William Rosenblatt. The Insurance Practice Group also includes insurance finance consultants Vincent Laurenzano and Charles Henricks. They gratefully acknowledge the assistance of Robert Fettman and Rachael Newman, associates in the group. This column is intended for informational purposes only and does not constitute legal advice.

has financial solvency requirements substantially similar to the requirements necessary for NAIC accreditation, such state is solely responsible for regulating the financial solvency of the reinsurer. To view H.R. 5637, visit the United States Senate's Web site at **www.senate.gov.**

NEW JERSEY – Senate passes Bill to prohibit the use of step-down provisions in businesses' motor vehicle liability insurance policies

On December 4, the New Jersey Senate passed Senate Bill No. 1666 that prohibits the use of "step-down" provisions in motor vehicle liability policies issued to corporate or business entities to lower uninsured or underinsured motorist coverage for employees to the limits of coverage available to the employees under their personal policies. Step-down provisions are designed to permit an insurer to reduce the coverage available to employees not individually named on their employer's business auto policy.

The New Jersey Senate Commerce Committee Statement indicates that this Bill reverses the effect of the case of *Pinto v. New Jersey Manufacturers Insurance Co,* 183 N.J. 405 (2005). In *Pinto*, the court held that as to a motor vehicle liability policy that names a corporate or business entity as a named insured, step-down provisions which limited uninsured or underinsured motorists coverage for employees of that entity that are not individually named on the policy are valid and enforceable.

Further, the Bill expressly provides that a policy that names a corporate or business entity as a named insured shall be deemed to provide the maximum uninsured or underinsured motorist coverage available under that particular policy to any individual employed by the corporate or business entity, regardless of whether the individual is an additional named insured under that policy, or is a named insured, or is covered under any other policy providing uninsured or underinsured motorists coverage. To view introduced Senate Bill No. 1666, visit **www.njleg.state.nj.us/2006/Bills/S2000/1666_I1.HTM**

MASSACHUSETTS – High net worth exclusion created in the Massachusetts Insurers Insolvency Fund

On November 5, Governor Mitt Romney of Massachusetts signed legislation that creates a high net worth exclusion with respect to the Massachusetts Insurers Insolvency Fund ("the Fund"). The Fund, a nonprofit entity consisting of insurers, is obligated to the extent of the covered claims against insolvent insurers existing prior to the declaration of insolvency and arising within 60 days after the declaration of insolvency that are less than $300,000.

A high net worth policyholder is defined as one with a net worth exceeding $25 million on December 31 of the year before the year in which the insurer became insolvent.

Following the legislation, the Fund (i) will not be obligated to pay first-party claims to a high net worth insured, (ii) has the right to recover from high net worth insureds for third-party claim payments, (iii) will not be obligated to pay a claim that would otherwise be a covered claim that is an obligation to or on behalf of a person who has a net worth greater than that allowed by the insurance guaranty association law and which the Fund has denied coverage to that claimant, and (iv) establishes reasonable procedures for requesting financial information from insureds on a confidential basis.

To view the original law, visit **www.mass.gov/legis/laws/mgl/175d-3.htm**, to view the amendment visit **www.mass.gov/legis/laws/seslaw06/sl060342.htm.**

Casual Observations

Physician Heal Thyself

Nobody feels sorry for doctors; in fact most of us bemoan their insensitivity, haughtiness and lack of bedside manner. But an inflexible health care system and sky-high malpractice insurance rates have pushed many physicians to consider changing specialties or giving up their practices altogether.

Recently we had a first-hand look at the unrelenting pressures of the field while spending an extended week-end visiting a physician friend of ours on the West Coast. During our stay, this poor fellow tried to juggle his appointments, visitations and administrative duties, while running back and forth to court to testify in a malpractice case against a fellow internist.

Watching him go through his daily paces prompted us to thank the good Lord for failing to bestow on us the brains necessary to pursue such a profession. The irony is that while healing others, our friend is destroying himself. He's even resumed smoking to deal with the stress.

So how are other doctors coping? Some grin and bear it, but others are getting out of the most pressurized specialties. *The New York Times* recently reported on highly trained specialists who are turning to cosmetic medicine. For less than a year's additional training, these doctors can begin making us look better rather than feel better.

As one former Brooklyn obstetrician-gynecologist put it, "the two fields are as alike as an apple and an orange . . . but when you clear up someone's acne or facial hair, they are as grateful as if you delivered their baby." She also loves the idea that her fees and hours are no longer dictated by managed care and that she now pays $20,000 in annual malpractice premiums — $140,000 less than she was paying as an OB-GYN.

At least she stayed in the medical field. In the mid-nineties, Dr. Robert Glassman, according to another Times story, was struggling along as a hematology-oncology specialist earning *only* $150,000 a year. When he saw other, less talented physicians earning seven-figure salaries as Wall Street consultants, he decided to make his move. Dr. Grassman now works for Merrill Lynch, spending most of his days evaluating drugs developed by start-up companies seeking seed money. He's mum on the subject, but in all likelihood, he's increased his annual income tenfold.

Whether it's Wall Street's siren song or the lure of liposuction that drives these physicians to leave their chosen fields, the pressures will only intensify on those who remain true to their calling. It's no secret that a good number of those performing this country's most critical work are not adequately compensated, but now many of our best and brightest medical minds are at the tipping point. We can only pray that for most physicians, the satisfactions inherent in their professions will continue to outweigh their frustrations. Otherwise, our advice is: *don't get sick.*

— W.C.

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Hotel Rooms: You must book your hotel room directly with the Hilton Pittsburgh. The room rate for IRES attendees is $139 per night for single-double rooms. Call group reservations at 800-445-8667 or 412-391-4600. The IRES convention rate is available until July 20, 2007 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 www.hilton.com/en/hi/groups/personalized/pitphhh_ire/index.jhtml to book a room online.

If registering after July 20, add $40.00. No registration is guaranteed until payment is received by IRES.

A $25 cancellation fee will be assessed if canceling for any reason.

SPECIAL NEEDS: If you have special needs addressed by the Americans with Disabilities Act, please notify us at 913-768-4700 at least five working days before the seminar. The hotel's facilities comply with all ADA requirements.

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CANCELLATIONS AND REFUNDS

Your registration fee minus a $25 cancellation fee can be refunded if we receive written notice before July 20, 2007. 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, 2007.

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

√ If you'd like to be on a panel, or put one together, at the IRES CDS in Pittsburgh next August, NOW is the time to let us know. Call IRES at 913-768-4700 and leave a message with David or Susan.

√ Want to run for the IRES Board of Directors? Now is also the time for that. Call the IRES office, or send an e-mail to ireshq@swbell.net.

√ The all-new and revamped IRES Web site is nearly complete. You'll see it soon at **www.go-ires.org**

In the next REGULATOR:

Robert Hunter Speaks Out

Bulletin Board items must be no more than 75 words, and must be accompanied by the sender's name, e-mail address and phone contact information. Submit plain, unformatted text without special font stylings, underlined hyperlinks or special margins and headings. A submission will be posted in the next edition of *The Regulator* as well as on the IRES Web site.

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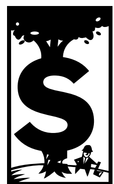

CAPCOs — what regulators should know. ***p.1***

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