The Regulator®
INSURANCE REGULATORY EXAMINERS SOCIETY

Bond insurers, once staid and stable, create regulatory anxiety

By Scott Hoober
Special to *The Regulator*

Insurance regulators have always had plenty to worry about. Life insurers were always looking for new niche markets and sometimes cut corners. Auto and homeowners insurers sometimes denied claims they shouldn't have. Medical malpractice bounced between one crisis and another.

Special Subprime Issue

But bond insurers? Sure, they guaranteed the interest and principal on something like $2.4 trillion of bonds**,** but what could go wrong? The bonds they were insuring were already highly rated and were issued by municipalities, counties, states and other taxing authorities, and seldom, if ever defaulted.

That's probably why, when bond insurers came to the New York department a decade ago and asked for expanded authority, there was little controversy.

So in 1998, bond insurers received authority from the New York department to indirectly sell protection for a variety of financial instruments, including collateralized debt obligations (CDOs) whose underlying assets could include subprime mortgages. The New York department allowed this noninsurance product — known as a credit default swap (CDS) — to be sold only by noninsurance subsidiaries called "transformers," with the bond insurer providing a financial guaranty to the transformer. **(Editor's Note:** For more information on CDOs, see Matti Peltonen's companion piece on p. 1.)

At the time, the change received little notice — except from bond insurers. And to be fair, insurers had authority to directly guarantee asset-backed securities starting in the late '80s, when these entities were first authorized. In addition, noninsurers also sell similar swaps. So the CDS market certainly can't be blamed for the ills the industry has suffered.

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Looking behind the subprime crisis

by Matti Peltonen

Subprime mortgages are loans to borrowers with less than perfect credit histories. Lending to subprime borrowers is a calculated decision. The higher interest rate is expected to compensate lenders for the higher probability of a credit loss. For borrowers, the subprime market has enabled many low-income families that would not have qualified for a traditional mortgage to buy a home.

Subprime Structured Securities

Most subprime mortgages are sold and structured into securities (thus the term "structured securities"), where the mortgage pool cashflows are sliced into different "tranches," and the best of those tranches get the highest (AAA) credit rating. The lower-rated tranches provide the credit support, absorbing all losses in

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From the President

Gateway to Regulator Excellence

THE GATEWAY TO REGULATOR EXCELLENCE is our theme for the IRES Career Development Seminar to be held in St. Louis from August 10-12, 2008. Many magnificent workshops have been planned for both regulators and the industry.

I would like to thank the Education Committee, chaired by Mike Hessler, and the dedicated section chairs who have assisted Career Development Seminar chairs Steve Martuscello and Dennis Shoop. Interested members may review the advance program on the IRES Web site.

In pursuit of excellence, the IRES Foundation will present the National Insurance School on Market Regulation at the Red Rock Resort, Summerlin, NV on April 13-15, 2008. The faculty consists of senior market regulators from 16 states and the NAIC. Also, the School will provide a special opportunity for insurers, attorneys, compliance professionals, consultants and others to learn what is happening in market regulation. Interested members may review the agenda at www.ires-foundation.org/register.html

Individual members can also strive for excellence from their computer. Our Webmaster Jo Leduc has designed and posted the IRES Research Pool Volunteer Form on the IRES Web site. The IRES Research Pool provides an avenue for IRES volunteers to contribute their expertise to the various National Association of Insurance Commissioners (NAIC) Committees, Task Forces, Working Groups and/or Subgroups.

The IRES Research Pool will include these general areas of expertise:

Annuities
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IRES for everyone!

To recognize regulator excellence, IRES is now accepting nominations for the Al Greer Achievement Award. Please review the details on the IRES Web site and help us to honor dedicated, hardworking regulators.

The Executive Committee, assisted by various subcommittees, has continued to work on various important projects. One of our plans is to clarify the IRES Bylaws. The Meetings & Elections Committee, chaired by Katie Johnson, will study the Bylaws and recommend appropriate changes to the Executive Committee.

To share expertise and experience, the Past Presidents Council, led by Kirk Yeager, has been invited to participate in IRES projects, such as Bylaw changes and various Requests For Proposal. Again, together we will empower IRES to be one of the best professional associations in the nation, which will help to build a better insurance world for consumers.

Finally, I would like to remind you that, under longstanding IRES policy, 2008 dues received after March 15 are subject to a late fee.

God Bless,

Polly Chan

Polly Chan, CIE
IRES President

Welcome, new members!

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Elections will be conducted in August during the 2008 Career Development Seminar in St. Louis. After the elections, the Board will elect new officers to the Society's seven-person Executive Committee.

Interested? Send an email to Katie Johnson, Meetings & Elections Chair, at:

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Regulating bond insurers

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Derivatives

But as the quest for debt to collateralize grew, so did low-doc and no-doc mortgage lending (loans issued with little or no income or asset documentation, sometimes called "liar's loans"), and what we later came to know as the subprime mess took off. And the bond insurers' role rose with it.

Over the past few years, those once careful, conservative bond insurers have guaranteed credit default swaps designed to transfer the credit exposure of fixed income products between parties on something like $100 billion in complex mortgage-backed securities.

Top Five U.S. Financial Guaranty Insurers, 2006

Company	Market Share
Ambac	27.2%
MBIA	19.5
Financial Security Assurance Group	19.3
Financial Guaranty Insurance Co.	12.9
XL America	10.6

Source: A.M. Best

Now, no one is saying that bond insurers or credit default swaps are the sole culprits for the economy's current contraction. There's a long list of culpable parties, from loan originators that bent the rules, to lenders that adopted a don't-ask-don't-tell mentality toward anyone who could bring in new loans, to skewed credit scores, to the folks who bundled mortgages into securities without looking at the value of the underlying assets, to the insurers that lent their credibility to those questionable securities, to the institutions that bought billions of dollars worth of debt without knowing, or much caring, whether they were worth the paper they were printed on.

But the bond insurers' role was certainly an important one, though they weren't the only counterparties offering CDS's: The credit default swap market totals more than $43 trillion today — larger than the entire bond market.

As Joshua Rosner, managing director of New York-based research firm Graham Fisher & Co., put it, "They were the nexus of the problem."

Though in hindsight a lot of the players seemed out to lunch, they're actually pretty smart people. Why would they plunk down big bucks for securities that in the end turned out not to have much value? Two of the answers to that question go directly to the bond insurers' role.

In the first place, as a so-called counterparty, the bond insurers (also known as FGIs, short for financial guarantee insurers, or as "monolines") loaned their pristine reputation to the enterprise, persuading many a buyer that the investment was risk-free — and even if it wasn't, that they would be repaid.

FGIs also loaned out their credit ratings.

Bond insurers until recently had safe, reliable Triple-A ratings, presumably based on the reliability of many of their core municipal clients, the adequacy of their reserves and the unlikelihood of defaults, particularly among municipals. So a school district with, say, a Single-A rating would wash its debt and get a Triple-A return by adding credit insurance.

The insurance wraps also increased the bonds' marketability. As the Web site of the Association of Financial Guaranty Insurers puts it: " Small or infrequent issuers are unknown to most municipal investors, and bond insurance may improve the market's acceptance of their securities."

When the bond insurers started investing in riskier kinds of structured finance, they kept those AAA ratings, lowering the cost of financing for anyone dealing with them. That switch from safe to risky investments is a major chapter in this whole mess.

As Rosner put it: "You've got companies that historically had a plain vanilla business — as a matter of fact, something of a cash register business. And they received pretty fat margins on what was a very low-credit-risk business.

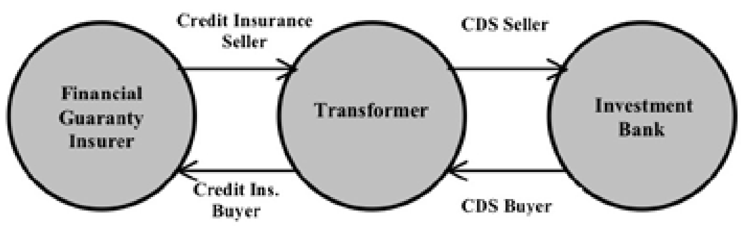
"The problem for these companies came when they decided that they were going to move in the late '90s and the early part of this decade into writing credit protection," he added.

When Ambac, MBIA, FSA and other bond insurers entered this new market, a lot of investment bankers began calling and seeking their services. How did they rise so quickly to such prominence?

The decision to pick them, says Rosner, "wasn't relative to some other insurance company. It was relative to some other counterparty.

"They could have gone to another counterparty, but in order to get the best pricing, they'd want to go to a counterparty that had a rating. Banks have to carry capital that's tied not only to the underlying asset, but to the quality of the counterparty. Since these companies were AAA, the cost of doing business with them was lower for the banks."

Typical Credit Default Swap (CDS) Transaction



Note: The Transformer company is a noninsurance subsidiary of the Financial Guaranty Insurer

In the end, the bond insurers underpriced their business, according to Rosner. They hadn't been providing this service in the past for one simple reason: insurance companies have traditionally not been allowed to get involved in derivatives.

We know why these companies would want to go in this direction: Margins in their core business were dropping. But how could they have been permitted to cross the line into derivatives?

In a 1998 letter to the New York State Insurance Department, FSA (Financial Security Assurance Inc., a unit of Dexia SA of Brussels) argued that swaps were similar to FSA's existing business: providing guarantees on other types of bonds, through insurance contracts.

Regulators' role

"From bond insurers' vantage point, this was identical to their core business," although it involved a different type of contract, said Bruce Stern, FSA's general counsel and the man who wrote the 1998 letter, in a recent *Wall Street Journal* piece.

The department went along with the interpretation, other states followed, and the rest is history. (Interestingly, FSA avoided the kinds of losses that have hit other bond insurers, according to Stern because it avoided the riskiest parts of the business.)

But, wait, under our state-based regulatory system, why didn't another department put the kibosh on the idea? Because most of the bond insurers are domiciled in New York, other states went along with the idea. (To be fair, there's no reason to think a single federal regulator would have done any better.)

The big change authorized a decade ago was the idea of a transformer.

"The New York State Insurance Department didn't say they could be involved in derivatives *per se*," Rosner said, "but that they could have a subsidiary business, which is called a transformer, that could."

Insurers set up straw men to do the business for them, though it isn't clear how this is different from a convicted felon buying a weapon by bringing his girlfriend into the gun store, telling her which handgun he wanted and handing her the money.

"So you've got companies [the left circle in the diagram above] that historically were not allowed to play in the derivatives market, yet because they were given permission to set up these transformers, these special purpose entities, they actually did end up with derivative exposures," said Graham Fisher's Rosner.

As soon as that happened, as soon as the bond insurers got into renting out their balance sheets and their Triple-A ratings, they outcompeted the other counterparties that didn't have those advantages. And they allowed a whole group of players to ignore the real risks of investing in credit default swaps.

On top of that, they somehow dodged regulatory oversight.

As Rosner put it, "They were essentially taking counterparty risks at spreads that were less than other market participants' counterparties would have charged."

Even with the regulatory change that authorized those transformers, there had to be state insurance

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Bond insurers under scrutiny

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examiners looking at the books of those newly transformed bond insurers. Doesn't a standard, run-of-the-mill financial exam involve looking at the numbers behind the numbers on the balance sheet?

"Typically, in a financial examination, we look at the balance sheet and the securities [underlying the numbers]," said an actuary with a Midwestern department not involved in examining bond insurers.

"To my mind — and this is an unpopular thing for me to say," Rosner said, "I would argue that it's sort of funny that the New York State Insurance Department is the lead in trying to orchestrate a solution, a bailout, given the fact that really, reputationally, it is a bailout of the New York State Insurance Department."

The department, he said, "helped the banks circumvent the regulatory capital requirements by creating arbitrage, because if you had insurance, you would have a different reserve exposure than if you actually just had a credit protection on the CDS."

And now they've been encouraging banks to shore up the bond insurers, which would avoid a downgrade, a downgrade that would increase the banks' own losses. Rosner compares the process to lending money to a life insurer when you learn, after your spouse's death, that they can't afford to pay the claim.

The New York department declined to comment directly on Rosner's accusations, referring readers to Superintendent Eric Dinallo's published remarks.

In a letter to Rep. Paul E. Kanjorski, chair of the U.S. House Subcommittee on Capital Markets, Insurance and Government Sponsored Entities, Dinallo reviewed how bond insurers got into the CDS business.

"Insurance law generally prohibits insurance companies from engaging in derivatives transactions," Dinallo acknowledged. ". . . FGIs wanted to offer credit default swaps because their investment bank customers, for accounting reasons, preferred them to bond insurance.

"The Department determined that, as a practical matter, there was little difference between the risks undertaken by insuring a credit default swap and issuing direct bond insurance."

The superintendent also acknowledged that his department hadn't been examining the value of the assets that underlie these insurers' balance sheets.

"Rather than relying entirely on the rating agencies to assess the FGIs' ability to continue to write new business," he told Kanjorski, "regulators may need to engage in an independent analysis of the risk positions of FGIs."

He added: "While this would require more and increasingly sophisticated resources, the Department is prepared to make that commitment."

What's next?

This is a fast-moving issue, with new revelations almost daily. At the time of this writing, a hot topic is Warren Buffett's offer to buy the healthy part of the bond insurers' portfolio. It would sure be a profitable move for the sage of Omaha, but it would also assist the only truly blameless victims in all this: the muni bond issuers.

As Rosner put it, "The only thing that anyone should have any sympathy or concern or pity for is the municipal bond insureds. Other than those folks, everyone else should have to suffer their risks and their losses, and the only thing that the insurance commissioners should be worrying about at this point is trying to prevent a seizing up of the municipal bond insurance market."

As for the monolines, he said, they messed up and deserve to go under.

But wait. If that happened, who would insure municipal bond issues? Sure, there are a couple of monolines that sat out the subprime fiasco, but they may not have the capacity the market needs.

One rational move, as unlikely as it might be, would be to let that happen. The remaining bond insurers could assist the few states, counties and other taxing authorities with less-than-stellar ratings by — as before — renting out their AAA ratings. But for the bulk of such issues, who needs 'em? As we now know, the municipalities themselves are better able to pay claims than the insurers. In fact, at most a bare majority of munis ever bought insurance.

Rosner says that if he were to suddenly be given Superintendent Dinallo's job, and a free hand to act as he wished, he'd put those insurers into receivership, wipe out the equity and, if he had to, repudiate a portion of their CDS exposure and put them in wind-down mode and ultimately into liquidation.

And, of course, rescind the rules that allowed them to get into derivatives.

"Frankly," he said, "one of the things that's perverted here is that there's no lack of available counterparties. There are plenty of noninsurance company counterparties out there — but they charge more because they're pricing the risk more successfully. (We couldn't get a monoline or the association of monolines to comment on the allegation that they underpriced their services.)

One last question: Should anyone be going to jail over this?

Rosner thinks not.

"Other than the fact that they were allowed to play in markets that they shouldn't have, I don't think there's anything that's not kosher, or that verges on illegal," he said. "I really don't. It was just bad risk management and decision making [by the insurers]," which is why he favors a thinning of the herd and letting some of the worst decision-makers fade away.

Sure, they messed up. But so did everyone else. The monolines may have been the most aggressive player, but no one walks away from this mess — which may yet go on for several more years — with clean hands.

There are certainly lessons to be learned, certainly for regulators.

If companies are seeking authority to get into a whole new line of business, take a really careful look before saying OK. And put the resources into doing examinations right, even if someone else has assured you that there's no need to look any more closely than you have been.

Most of all, remember that the core skill of insurance company CEOs, actuaries and regulators alike is evaluating risk.

As a wise man once said: "Risk is the price you thought you'd never have to pay."

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"This is probably the best session on market conduct that I have ever attended."

— Don Koch, former IRES President

The IRES MCM (formerly MC+) program offers individuals the opportunity to learn the mechanics of conducting a market conduct examination in an efficient and effective manner. It also allows participants to learn how states handle a variety of different situations during the course of an examination.

Those completing the program will be awarded the Market Conduct Management (MCM) designation.

Following a successful pilot class last year, IRES is conducting its first class of 2008 at the Wisconsin Insurance Department, March 17-19. On July 14-16, a class in Baton Rouge, LA, is scheduled. Another will be held in St. Louis on Aug. 13-15 during the three days that immediately follow this year's Career Development Seminar.

In addition, a class in Richmond,VA, is planned for early 2009.

Only 30-35 participants will be permitted to enroll in each class. The class is open not only to regulators, but also to independent contactors, industry personnel and attorneys.

The cost for each class is as follows:

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IRES general member $395
IRES sustaining member............................ $750

Non-members

Non-member regulators $675
Other non-members................................... $950

Those interested in enrolling or with questions about the MCM program should contact Jo LeDuc at 608-267-9708 or **jo.leduc@wisconsin.gov.**

Peltonen on Subprime

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the mortgage pool. The AAA tranches only lose money once the lower tranches are all eaten up by losses — even if the AAA tranches' rating is lowered before they suffer actual losses in the cashflow, as the credit support for them erodes. Typically, the default rate in a prime mortgage pool is below 1%. The default assumption for subprime loans was about 5%, and to provide a sufficient margin, AAA securities were structured to withstand at least a 15% default rate. The assumptions were partly based on the fact that there had never been a country-wide fall in house prices since the Great Depression.

> ***"As investors, U.S. insurance companies had very moderate exposure to subprime."***

A perfect storm developed in the market during the past years. The demand for securities grew and, as securities firms competed for a finite pool of mortgages, less attention was paid to loan quality. Loan terms had changed so that the traditional 20% down payment safety cushion was no longer required. In fact, buyers could obtain a mortgage that exceeded the value of the house — and that value was often already inflated. Fraud increased among mortgage brokers, and predatory lending increased. Loans were granted to people who could ill afford them and who did not understand the terms — especially the teaser rate and the subsequent rise in interest rate. The lending frenzy led to a higher demand in the housing market and rising prices, which led to more subprime loans.

The bubble burst in 2007 and we now find a housing market in its worst shape since the Great Depression.

Subprime Investors

Since the subprime market — and the general structured security market — collapsed in 2007, banks and broker-dealers have absorbed over $100 billion in losses from their subprime holdings. These entities had invested in subprime securities as an investment on their own balance sheets. Once the capacity of the market to absorb the lower-rated tranches dwindled, banks and broker-dealers sometimes kept those tranches, in order to be able to finalize and sell the other tranches of a subprime security. In a recent G7 meeting, the total losses from the U.S. subprime crisis were estimated to rise as high as $400 billion.

Many others also invested in subprime securities — which did, after all, have the highest ratings, and therefore, a minimal probability of serious trouble, let alone a default. Those investors included individuals through mutual funds, hedge funds, municipalities, governments, etc.

The FGIs, just as most other insurance companies, were not large buyers of subprime securities. But as the FGIs' insurance business is to guarantee payments on securities, they got heavily involved through those guarantees — about $800 billion in total in structured securities, including subprime collateral.

Market

Trading in subprime securities takes place in the over-the-counter market. Once the news about the increased default rates and the first round of downgrades hit the market, buyers largely disappeared. There was an unprecedented decline in value for these highly rated securities, even the AAA rated securities fell by 20 to 30%, making divesting unpalatable to most investors. Some investors — like those hedge funds that were heavily invested in subprime securities — had to sell, which led to further drops in the market.

The market malaise spread to the structured securities market in general. Except for the traditional (prime) residential mortgage-backed securities (RMBS) market (with federal agency guarantees), the issuance of structured securities has fallen sharply.

As a result of the falling market, some hedge funds have liquidated and some foreign banks have been bailed out. The share prices of many financial institutions have fallen sharply. There is fear that not all losses have been shown, and that those losses are getting worse. Some broker-dealers have announced two or more rounds of subprime losses.

Many mortgage brokers have closed, and some larger ones — like Countrywide — have been absorbed by banks. As the mortgage business is stagnant at best, layoffs have ensued, not only among mortgage brokers, but also among those who structured and traded these securities.

Rating Agencies

The rating downgrades (sometimes several rounds of downgrades) for thousands of securities demonstrate the extent to which the rating agencies failed to sufficiently anticipate the rise in default rates. The AAA rating for subprime securities has turned out to be far less stable than the same rating for a corporate bond. Moody's chief executive conceded to *The New York Times* in late January that the firm had made "significant mistakes in the rating of structured finance products" and had been "deceived by people who put together the products."

Many AAA tranches have been downgraded, some of them by many levels. Many of the lower-rated support tranches have been eaten up by losses, and defaulted. Even if rating agencies are private companies that only express credit opinions, the market had come to rely on them. The products were selling so fast that buyers often had little time for in-depth credit analysis, so they relied on ratings. Rating agencies have, not surprisingly, been subject to sharp criticism. There have also been calls for better oversight and a change in the whole rating agency model.

Insurance Companies

As investors, U.S. insurance companies had very moderate exposure to subprime. Their investment portfolios are typically well diversified, across a multitude of different investments, predominantly in fixed income. Typically, structured securities represent only a small percentage of the total, and only a small portion of those that are subprime. Most subprime investments have been AAA, and even if some have been downgraded, the expected cash flow losses are moderate for buy-and-hold investors. Even if the AAA deal was structured to withstand 15% of defaults, and the actual defaults rose to 17% over time, the cashflow shortfall would be two percentage points, thereby lowering income — but hardly a catastrophe on a cashflow basis. The market value, however, would have fallen sharply due to the resulting lower credit rating and the lack of liquidity.

Financial Guaranty Companies

The FGIs are a different story, because of their exposure to subprime through their insurance business. As FGIs grew and competed for business, they expanded from their traditional municipal bond business into structured securities. Just like rating agencies, they based their modeling assumptions on historical experience of the housing market. Their typical "slice" of the business is even safer and sounder than AAA — they mostly insured a "super senior AAA" tranche, where they had both AAA and lower rated tranches supporting them. If the "attachment point" for AAA was 15%, then their safety cushion for the super senior tranche might have been 20% — so 20% of borrowers in a subprime loan pool they insured could default, and the FGIs' cashflow would still be intact.

The first problem was that even well before there would be a shortfall in cashflows, all tranches in the deal would be downgraded, including the AAA. The problem from FGIs' point of view is that their capital is allocated in accordance with the risk they insure — and that risk is based on the rating. The lower the rating, the higher their need for capital — until ultimately, the required capital rose to a level where the FGIs' own AAA ratings were in jeopardy. And as an FGI's business model going forward is based on the maintenance of that AAA rating, the loss of the rating would mean a virtual runoff. Not all FGIs were impacted — some have largely stayed away from structured finance deals, at least the riskier end of them, and their AAA ratings are solid.

To date, some previously AAA rated FGIs have been downgraded, and others have been put on a negative or downgrade watch. Unless those FGIs are successful in their capital-raising efforts, they will have difficulty retaining their AAA rating. In the current market, there

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is no affordable way for FGIs to reduce the subprime and other structured finance risk exposures. The only way to maintain their AAA rating is through new capital. Ambac and MBIA are publicly traded and their share price has fallen 80% to 90% from their highs. MBIA has managed to raise capital through the issuance of a surplus note, through a private equity deal, and issuing more common stock. The French owners of CIFG, another financial guaranty insurer, already capitalized it last November.

> ***"Although traditional life and p/c insurers do not appear significantly affected by the subprime mortgage crisis, financial guaranty companies are a different story."***

From a solvency perspective, FGIs are unlikely to be in trouble (except ACA, a smaller FGI which was rated A, and was downgraded to CCC) and they should be able to pay their claims. Their liquidity position is good, and helped by the fact that most policies cannot be accelerated, i.e., they guarantee payments as they are due, in many cases decades from now.

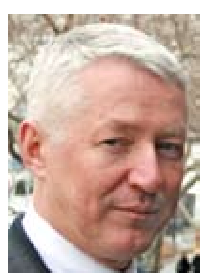
The biggest single problem for FGIs appears to be the guarantees associated with "CDO squared" deals.* Their risks are not purely based on cashflows, where the likely loss would be marginal (to the extent that defaults exceed the safety cushion). The collateral, mezzanine tranche of the inner CDO is controlled by the senior tranche of that inner CDO.

When the RMBS (collateral of the inner CDO) is downgraded, the owner of the senior tranche in the inner CDO can force liquidations of the RMBS tranches, and sometimes those liquidations take place at a fraction of the face value — as the market is very illiquid. Those liquidations can cause much sharper losses to FGIs at the CDO squared level than the expected cashflows from the subprime loans in the pool would — even at higher default levels. Those losses can also take place faster — as there is unlikely to be enough cash in the pool, forcing the FGIs' to pay through the insurance policy.

Conclusion

Although traditional life and p/c insurers do not appear to be significantly affected by the subprime mortgage crisis, financial guaranty insurers are a different story. Since the main focus of regulating financial guaranty companies is insolvency, the regulatory framework with respect to FGIs needs to change. The capital requirement resulting from different credit ratings in the bonds FGIs insure may need to be more granular — a BBB rated structured security carries much more risk than an AAA rated security; and that difference is greater than the risk differences among different municipalities.

On one hand, though, it can be argued that as the rating agencies failed to adequately anticipate the risks embedded in structured securities, the regulation has to distance itself from being too rating-dependent. Some of the activities the FGIs engage in — such as CDO squared deals — may need to be reexamined or restricted, unless the FGIs can show their modeling and levels of capital are sufficient to continue taking on such risks. ■



Matti Peltonen is Chief of the Capital Markets Bureau of the New York State Insurance Department.

* A CDO is a security backed by a pool of bonds, loans and other assets. A "CDO squared" security is essentially a CDO backed by other CDOs.

A Regulatory Approach to Fraud After a Catastrophe

by Leslie Kim and Barry Zalma

After a catastrophe regulators are faced with a dilemma. They must ensure that policyholders who have suffered a loss are fairly compensated while recognizing that insurers also need protection from opportunistic fraud. For example, while the wild fires of October 2007 were still burning, California regulators authorized insurers to bring in unlicensed adjusters from out of state to serve victims in a timely fashion while, at the same time, they created a task force to deal with fraud-related problems that arose as the result of the catastrophe.

In establishing the task force, regulators recognized that after a catastrophe: (a) billions of insurance dollars flood into the location to indemnify policyholders, (b) insurers send in teams of insurance adjusters to assess the damage from damaged or destroyed property, and (c) fraud perpetrators try to milk as much money from the insurers as possible. They also recognized that it's anybody's guess which group moves the fastest, but that crooks have a distinct advantage because after a catastrophe insurers are so preoccupied with providing top-notch service to affected policyholders that they momentarily lower their fraud-defense shields.

Insurance regulators are charged by their states with a duty to protect the public. This obligation is amplified by a catastrophe. Regulators must be prepared to deal with the inability of insurers to adequately handle the high volume of claims. They must also approve adjusters who are not licensed in the state and police dishonest or incompetent insurance claims adjusters and unscrupulous public insurance adjusters.

As the fires swept through Southern California, the vast majority of those watching on television were thinking about the victims, the homes and the immense tragedy. Viewers saw lost pets, charred toys, tear-stained faces and fire-ravaged neighborhoods. At the same time, those closer to the insurance industry were working to adequately staff their claims operation in Southern California and ensuring that their catastrophe teams focused on arson, crime, and fraud while providing relief to honest claimants. It indeed presented a conundrum.

The entire concept of insurance, the spreading of the risk of loss, is a mystery to most. Many consumers view insurance as akin to playing a slot machine. Put the money in. Pull. See if anything comes out. Most will not hear the payoff bells ring, some will get a small return, and a rare few will receive what could be described as a jackpot. What the public does not understand (and, to be honest, what many in the business of insurance do not understand either) is that there is little risk in the insurance equation. With potential loss probabilities computed on astronomical amounts of data and with an increased reliance on the absolute cost of doing business (CODB), insurers are seldom surprised by long-term losses. Even major catastrophes are often just small blips on their radar screens.

Fraud after catastrophes

Fraud has become an ever-escalating problem over the past few decades. It is part of the CODB equation and quickly passed on to the insurance-buying public. When catastrophe strikes, those insurers with staffs that are not adequately trained to investigate and adjust claims compound the suffering of victims while adding to the costs of insurers. The following are some typical situations insurers may encounter in catastrophes:

Policyholders: Peter and Penny Poway (all names in examples are fictional) were evacuated from their home just hours before fire struck. When they were eventually allowed to return, they found only a pile of charred rubble. In the coming months, throughout the difficult claims-adjustment process, both insurers and policyholders will be tested. Is the insurer offering the Poways fair value? Did Penny really lose 50 pairs of shoes purchased from Nordstrom and Saks? Did Peter's fishing rod really cost $500?

Adjusters: Is Freddie Adjuster steering business to his brother-in-law Charlie Contractor?

Contractors: Does Charlie pad his profits by cutting corners or using substandard materials?

Public adjusters: Are they more interested in a quick settlement and their contingency fee than fully indemnifying the insured?

Companies: Do they interpret their policies "creatively"? Do they refuse to pay covered claims?

The list is nearly endless. Every person and every entity involved in this tragedy can affect the honesty of the overall process. As regulators know, fraud is pervasive; it can creep into every segment of an insurance transaction.

A proposal

If the insurance industry truly wants to minimize fraud, the single obvious answer is *education*. Every individual entrusted with the privilege of working in the insurance industry must be educated in both its processes and products. This would reflect a proactive approach to insurance fraud rather than a reactive one.

To be certain that consumers are fairly compensated for their losses, insurance regulatory agencies must ensure that every insurer train its personnel up to competence. It does little good for an adjuster to realize after the fact that he paid bogus claims during a catastrophe. Being proactive, managing the need **NOW**, is the far better answer.

It should be the responsibility of insurance regulatory agencies to require insurers, their claims personnel, independent insurance adjusters and public insurance adjusters, to be licensed, competent and well trained. Training should cover such areas as basic insurance principles, insurance claims handling, and fraud recognition techniques.

Personnel should also be familiar with state insurance laws so that they can competently adjust claims and combat fraud. Thus, each person involved in the claims process — from the clerk who takes in the first notice of loss to the executive who has the final say on the largest claim paid — should be trained and knowledgeable in the following areas:

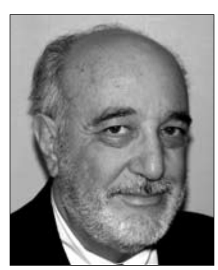
- Insurance, its history and modern application;
- The Fair Claims Settlement Practices law of the state and the regulations promulgated to enforce the law;
- How to read, understand and interpret insurance contracts;
- Investigation techniques including, but not limited to, interviewing, photography of loss scenes, use of independent experts, use of private investigators and use of claims counsel;
- Insurance fraud and fraud recognition, the operation and use of Special Investigative Units (SIUs) within insurance companies, and a thorough understanding of reporting to fraud bureaus of state insurance departments;
- The special fraud investigative unit laws and the regulations promulgated to enforce them; and
- The law of contracts and torts needed by claims professionals to competently adjust claims.

Moreover, individuals should not merely be required to attend training; they must demonstrate an understanding of core concepts and principles. Such a requirement need not be onerous or time-consuming. Computer-based training programs can be completed incrementally while the student drinks that first cup of morning coffee.

Learning results are measurable and can be monitored by testing. The insurer can electronically receive a record of the training time of each individual plus test results. An individual who uses computer-based training six minutes a day, five days a week for 50 weeks will have received 25 hours of training during a year. Another plus to this approach is that ongoing training keeps the subject matter fresh and in the forefront of one's mind.

Training is a beginning, not a panacea. Regulators must audit and enforce the requirement that insurance personnel are well trained and that they are actually using the training to provide the service that policyholders and claimants deserve. ■

Leslie Kim is Editor of The John Cooke Fraud Report (www.johncooke.com) and Executive Director of Fight Fraud America (www.fightfraudamerica.com). Barry Zalma, Esq., is President and Founder of ClaimSchool (www.claimschool.com) an online claims training site, the founder of Zalma Insurance Consultants and the publisher of Zalma's Insurance Fraud Letter at www.zalma.com.

IRES membership soars to new heights

Are you getting the most out of your IRES membership?

Over the last year or so, the IRES Membership & Benefits Committee has been working hard on finding new ways to enhance the value of your IRES membership at no additional cost to you. Recently, IRES began offering IRES members two new benefits related to travel and continuing education.

IRES has entered into an agreement with Carlson-Wagonlit Travel to provide travel services to all members. IRES General Members and Sustaining Members can use the services of Carlson for both business and personal travel. Carlson can provide IRES members with all forms of group and individual travel service at highly competitive rates.

So if you have a business trip to arrange and aren't required to use a specific travel agent, consider taking advantage of the online booking services of Carlson or booking through one of their travel agents.

If you want to book a vacation, Carlson may be just the place to start planning that perfect getaway. Through the IRES Vacation Program, members are eligible to receive exclusive specials and great pricing when booking vacation packages through Carlson. Members can also work directly with a travel specialist to create a customized vacation package to fit any budget.

Information on how to begin using the travel services offered by Carlson is located in the Membership Discount Programs section of the Members Area on the IRES Web site, **www.go-ires.org**.

In addition, General Members of IRES with voting rights (*i.e.*, regulators, including independent contractors) can take advantage of substantial discounts on the products or services offered by LOMA, the Insurance Data Management Association (IDMA), and the American Institute for Chartered Property Casualty Underwriters/Insurance Institute of America (AICPCU/IIA).

That means General Members who do not already have access to discounted fees through their employer can now obtain substantial discounts (up to 50% on the examination fee) through IRES when taking examinations or courses offered by one of these entities. So whether you're testing because you are working toward your AIE or CIE; earning one of the many designations offered by these organizations; or simply earning continuing education credits, you may be able to take advantage of these discounts.

Additional information on eligibility for these discounts and details on how to start taking advantage of them can be found under the Membership Discount Programs section in the Members Area of the Web site.

The Membership & Benefits Committee will continue to add exciting benefits to enhance your IRES membership. Please e-mail any suggestions for potential new benefits to Holly Blanchard at **Holly.Blanchard@doi.state.ne.us**. ■

IRES CHAPTER NEWS

DC — The DC Chapter held its first bi-monthly meeting on January 8. We devoted some time to reflect on the special people who have contributed to our lives. The essence of our first meeting was to brainstorm and determine the best approach to providing continuing education and attracting new members. **Betty M. Bates**, DC Department of Insurance, Securities and Banking, Enforcement and Investigation Bureau, Fraud Compliance Manager, gave CDS and IRES updates. Also, we inadvertently left out of our past Chapter News update the fact that the NAIC's **Joseph Bieniek** addressed our September 28, 2007 continuing education meeting.
– Hazel Mosby; hazel.mosby@dc.gov

LOUISIANA — The Louisiana Chapter met on February 13. We discussed and voted on proposed amendments to our Chapter By-Laws. In addition, **Trent Beach**, Director of the Fraud Division provided an overview of its operations. A question-and-answer session followed his presentation.
– Larry Hawkins; lhawkins@ldi.state.la.us

MISSOURI — The Missouri Chapter met on January 7 in Jefferson City. The program included an overview of the new IRES "MCM" course. The program was outstanding. The class featured an excellent discussion that resulted in a number of great suggestions for improving the text. The textbook will require additional editing pending completion of negotiations with the NAIC. Several additional classes have been scheduled, including one for St. Louis following the 2008 CDS.

We also reported that IRES is continuing to work on planning a concurrent CDS with SOFE. This is still in preliminary stages and we are hopeful that details can be worked out for 2012.

Missouri chapter members expressed a desire that IRES add, or develop, a Title Insurance course (with a proctored examination) for the AIE designation as part of the P&C path. Interest was also expressed for IRES to develop a program for an Automated Examination Specialist designation.
– Gary W. Kimball, CIE; Gary.Kimball@inexam.mo.gov

"Quote of the Month"

"While we are doing all we can to protect policyholders and strengthen the bond insurers, we must work with other financial regulators to ensure that consumers and municipalities do not bear the brunt of subprime excesses."

— New York Superintendent Eric Dinallo testifying before the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

Regulatory Roundup

by
Stroock & Stroock &
Lavan LLP

Connecticut — Insurance Department exempts certain commercial lines from filing requirements

On January 7, the Connecticut Insurance Department issued Bulletin PC-63 in which it announced a one year pilot program exempting several commercial lines from rate, form and rule filings. Exempt commercial lines include, among others, inland marine, excess and umbrella, credit, flood, fidelity and surety bonds, boiler and machinery, and financial guaranty insurance. In an effort to assess the effectiveness of the pilot program, the Department will continue to require insurers to provide, for informational purposes, the rates and forms filings exempted by the Bulletin.

The Bulletin also requires an officer of the insurer to certify that the exempt filing complies with applicable insurance laws and regulations and that the filing was not previously disapproved by the Department. Bulletin PC-63 is effective for filings received by the Department on or after February 1, 2008. To view Connecticut Insurance Department Bulletin PC-63, visit **www.ct.gov/cid/lib/cid/BullPC63.pdf.**

Michigan — Bill restricting use of insured's credit information is introduced

On December 13, the Michigan House of Representatives introduced HB 5565, a bill modeled on the National Conference of Insurance Legislators ("NCOIL") Model Act on Credit-Based Scoring, which would prohibit an insurer from using credit information or an insurance score as any part of a decision to deny, cancel, or nonrenew a personal insurance policy. Personal insurance is defined as property/casualty insurance written for personal, family, or household use, including among others, automobile, home, boat, and recreational vehicle, whether written on an individual or group basis.

The Bill also prohibits the use of credit information or a credit-based insurance score in the rating or underwriting of personal insurance unless among other requirements (i) the insurer or its producer discloses, either on the insurance application or at the time the application is taken, that it may obtain credit information in connection with the application; (ii) an insured's income, gender, address, zip code, ethnic group, religion, marital status, or nationality is not considered in calculating an insurance score; and (iii) the insurer does not take an adverse action against an insured solely because he or she does not have a credit card account, without consideration of any other applicable factor independent of credit information.

HB 5565 was referred to the House of Representatives' Committee on Insurance. According to published reports, NCOIL's Model Act has been enacted in 26 states, though a similar measure to ban credit-based insurance scoring was recently defeated by the Colorado House of Representatives. To view HB 5565, visit the Michigan House of Representatives Web site at **www.legislature.mi.gov.**

New York — Governor signs loss-cost approach for workers' compensation rates

On January 31, Governor Eliot Spitzer signed Assembly Bill 9817 into law, shifting New York from the current "administered pricing" approach to a "loss cost" approach in determining New York's workers' compensation rates. Prior to the legislation, New York was in the minority of states that did not rely on a loss-cost system to set its workers' compensation rates.

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

Instead, insurers submitted workers' compensation claims data to the New York Compensation Insurance Rating Board ("NYCIRB"), which recommended manual rates for approval by the New York State Insurance Department. Under the new law, effective February 1, 2008, a rate service organization ("RSO") may develop loss costs that must receive Insurance Department approval and represent the anticipated costs of claim payments and loss adjustment expenses associated with such claim payments, but does not include provisions for expenses (other than loss adjustment expenses) such as acquisition costs, overhead and taxes, or profit. Each insurer must also submit its individual loss-cost multiplier, determined by expenses, to the Insurance Department for approval.

The Bill was designed to remedy legislation passed in March 2007 that would have precluded a workers' compensation RSO from filing rates or statistical information with the Insurance Department and exchanging statistical information with insurers or other RSOs after February 1, 2008. The Bill also changes the governance structure of a workers' compensation RSO by requiring that its governing body have nine members, a majority of whom cannot be representatives of private carriers. Non-private members on the governing body are to include the New York State Insurance Fund and designees of the Insurance Department, the Workers' Compensation Board, the AFL-CIO and the Business Council of New York State, Inc. To view Assembly Bill 9817, visit **www.assembly.state.ny.us/leg/?bn=A09817.**

U.S. — Treasury Department publishes interim guidance on TRIA renewal

On January 28, the United States Treasury Department published interim guidance concerning the Terrorism Risk Insurance Act of 2002 ("TRIA"), as recently amended by the Terrorism Risk Insurance Program Reauthorization Act of 2007 ("Reauthorization Act"), in the Federal Register. Among other provisions, the Reauthorization Act revises the definition of "act of terrorism" to remove the requirement that the act be committed by an individual acting on behalf of any foreign person or foreign interest in order to be certified as an "act of terrorism" under TRIA. The interim guidance notes that there is no change to the TRIA requirements that insurers make available in all property and casualty insurance policies coverage for losses arising from events other than acts of terrorism. However, because the "make available" requirements apply to "insured losses," and an "insured loss" is defined, in part, as a loss resulting from an "act of terrorism," the revision of the definition of an act of terrorism in the Reauthorization Act to eliminate the "foreign person or interest" element (*i.e.*, to add what is often referred to as domestic terrorism) may have an impact on an insurer's compliance with the "make available" requirements.

Accordingly, the interim guidance advises that any initial offers of coverage, or offers of renewal of existing policies, made on or after the Reauthorization Act's date of enactment (December 26, 2007), must be consistent with the revised definition of act of terrorism if an insurer wishes to receive federal compensation under TRIA. The interim guidance also considers March 31, 2008 to be the latest reasonable date for insurers to comply with the disclosure requirement to policyholders of the existence of the $100 billion cap.

To view the Treasury's interim guidance, visit the Federal Register's Web site at **www.gpoaccess.gov/fr/index.html.**

Casual Observations

Insurance Movie Classics: The Top Ten

With all the Academy Awards hoopla last month, you may have missed the unveiling of the Insurance Information Institute's top ten insurance films of all time. Here, starting with #1, are the Institute's choices:

Double Indemnity (1944): It's hard to find anyone who doesn't love this film noir classic starring Fred MacMurray, Barbara Stanwyck and Edward G. Robinson. Those who know MacMurray only as the bumbling father in "My Three Sons" or the befuddled inventor in "The Absent-Minded Professor" may be stunned by his dark portrayal of an insurance agent gone bad.

Memento (2000): This film focuses on an ex-insurance investigator plagued by short-term memory loss. The film features an imaginative conceit: it starts at the end and moves to the beginning. We saw it shortly after its release, but arrived five minutes late and remained clueless for the remaining hour and a half. We haven't arrived late to a film since.

The Fortune Cookie (1966): Jack Lemmon and Walter Matthau team up to commit insurance fraud. Who ever thought insurance fraud could be this funny?

The Killers (1946): A film loosely based on a 1927 short story written by Ernest Hemingway. The tale has actually been the basis of four other films, but this version was the first and probably best. Burt Lancaster and Ava Gardner star.

Save the Tiger (1973): As Harry Stoner, Jack Lemmon once again attempts insurance fraud, but this time there is no Matthau and tears replace the laughs. Lemmon captured a Best Actor Oscar for his convincing portrayal of a man at the end of his rope.

Rainmaker (1997): Francis Ford Coppola meets John Grisham in this tale that pits an unyielding health insurer against a woman seeking a bone marrow transplant for her ailing son. Regulators should enjoy watching the insurer's arrogant CEO — played convincingly by the late Roy Scheider — get his comeuppance.

The Thomas Crown Affair (1968 and 1999): In the 1968 film, Faye Dunaway plays the beautiful insurance investigator hot on the heels of well-heeled rogue Steve McQueen. The 1999 version featured Pierce Brosnan and Rene Russo.

Sicko (2007): Although this Michael Moore movie was an important and compelling release, it's a documentary that doesn't quite fit in with the Institute's other fiction-based selections. We would have chosen "About Schmidt" in which Jack Nicholson — as actuary Warren Schmidt — engages in some memorable post-retirement shenanigans. Bad boy Nicholson as an insurance company actuary: now that's counter-intuitive casting!

To Catch a Thief (1955): The Hitchcock classic stars Cary Grant as John Robie, a retired cat burglar and chief suspect in a recent jewel theft. John Williams plays the Lloyd's of London insurance investigator who uses a thief to catch a thief.

Along Comes Polly (2004): Ben Stiller as Reuben Feffer is a risk analyst who likes to play it safe until, that is, he bumps into old childhood chum Polly, played by Jennifer Aniston. Polly teaches the uptight analyst that there's more to life than risk avoidance.

We'd like to congratulate the Insurance Information Institute for assembling this list of great insurance films. In fact, we suggest IRES members rent one of these classics this weekend. Perhaps you'll even convince your significant other that insurance really isn't boring. For more details on these films as well as a list of titles that failed to make the cut, visit: **www.insurancenewsnet.com/article.asp?a=top_pc&id=91065**

— *W.C.*

ST. LOUIS

2008 IRES Career Development Seminar

AUGUST 10-12, 2008 RENAISSANCE GRAND HOTEL

Fill out and mail to IRES: 12710 Pflumm Rd, Suite 200, Olathe, KS 66062

Registration Form

Yes! Sign me up for the IRES Career Development Seminar.
Enclose a check payable to IRES or go to our Web site and pay online.
www.go-ires.org

Name

Title First name for Badge

Insurance department or organization

Your mailing address Indicate: ☐ Home ☐ Business

City, State, ZIP

Area code and phone

$ Amount enclosed or pay online

Seminar Fees

(includes lunch, continental breakfast and snack breaks for both days)

Check box that applies

- ☐ IRES Member (regulator)..............$320
- ☐ Industry Sustaining Member.. ....$540*
  - *REQUIRED: Sustaining Member # SM______
  - Lost your number? Send e-mail query to: ireshq@swbell.net. Provide company name and contact information.
- ☐ Retired IRES Member...................$125
- ☐ Non-Member Regulator...............$460
- ☐ Industry, Non-Sustaining Member.............................$940
- ☐ Student Sustaining Member............$80
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PAID Spouse/Guest name

Hotel Rooms: You must book your hotel room directly with the Renaissance Grand Hotel. The room rate for IRES attendees is $119 per night for single-double rooms. Call group reservations at 800-397-1282 or hotel direct at 314-621-9600. The IRES convention rate is available until July 10, 2008 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 link to book a room online: http://marriott.com/stldt?groupCode=ireirea&app=resvlink.

CANCELLATIONS AND REFUNDS

Your registration fee minus a $25 cancellation fee can be refunded if we receive written notice before July 10, 2008. 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, 2008.

Insurance Regulatory Examiners Society®

If registering after July 10, 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.

SPECIAL DIETS: If you have special dietary needs, please circle: Diabetic Kosher Low salt Vegetarian

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

BULLETIN BOARD

√ Don't wait to book a room in St. Louis for the 2008 Career Development Seminar. Our room block sells out quickly. Get your room now, register for the seminar later.

√ Yes, your state can "register" you for the CDS even though your registration fee can't be processed until July 1. If you are certain you will be attending the CDS, submit the registration form now! On the registration form, indicate clearly when the check will be sent, and a name and phone number for the person/agency issuing the check. See **www.go-ires.org** for more information about the St. Louis CDS and how to register.

In the next REGULATOR:

What's reasonable and customary about health insurance co-pays?

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 (no special font stylings, underlined hyperlinks or special margins). Email to Wayne Cotter at: quepasa1@optonline.net.

√ **Correction**: The January 2008 issue of *The Regulator* erroneously listed the price of the MC+ class for non-member regulators as $495. The correct price is $675.

The Regulator®

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Looking behind the subprime crisis.

See story, p. 1