The Regulator®
INSURANCE REGULATORY EXAMINERS SOCIETY

# What are the lessons for insurance regulators from the economic crisis?

Every five years since 1999, *The Regulator* has asked leaders in the insurance community to comment on a question of significance to state insurance regulators. In 1999, it was Marty Frankel's $200 million looting of insurance companies in several states that prompted the question: "Is State Insurance Regulation Dead?"

At this year's Career Development Seminar we thought it ironic that one speaker pointed to the Frankel fraud as evidence of how *well* state insurance regulation had performed. After all, even though several states failed to uncover the scam, he said, others were there to pick up the slack. He has a point.

Then in 2004, we asked "Where is State Regulation Headed?" Back then most respondents felt state regulation had bounced back from the Frankel crisis, but urged state regulators to remain vigilant in the face of federal encroachment. There was much talk of the State Modernization and Regulatory Transparency (SMART) Act, being introduced back then with a great deal of fanfare. We haven't heard much about the SMART Act in recent years.


This year, selecting the right question was a no-brainer:

*What are the lessons for insurance regulators from the current economic crisis?*

Nearly 80% of business economists tell us that the "Great Recession" is now over. Of course these are the same economists who failed to predict the economic crisis in the first place. Judging the distance to that light at the end of the tunnel can be precarious.

In 1936, most major economic indicators (except unemployment) had returned to their pre-1929 levels and economists were pronouncing the Great Depression dead and buried. By 1937, it was back with a vengeance.

Most observers, including many members of Congress, have agreed that regulatory deficiencies contributed significantly to the current crisis, but how to remedy such deficiencies is another story. The financial services industry is spending millions lobbying to ensure that our financial regulatory systems do not stray too far from the status quo. As a result, proposed legislation is getting watered down on a near-daily basis. It seems our elected federal representatives have already forgotten how perilously close this country came to economic collapse *and why*.


Of course most state insurance regulators feel the focus of any regulatory reform effort should

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# *Regulatory lessons*

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be on those responsible for overseeing the banking and securities industries, not on state insurance departments. In fact, had state insurance regulators been as lax as their financial services counterparts, we might now all be federal employees.

This is why it is so important for state insurance regulators to study the lessons of this economic crisis. The failure of regulators to learn from past mistakes could lead to the demise of a regulatory system that has served consumers and the insurance community for well over a century. As contributor **Kevin Foley** notes in this issue, the insurance industry has been an American success story since the end of World War II, yet the complaints about burdensome regulation continue.

Many critics of state regulation are already looking to the current crisis as justification for implementing an optional federal charter. Just think what they'd be saying if state insurance regulators had *not* acted responsibly.

As in past special issues, we have reached out to insurance commissioners, elected state and federal representatives, consumer advocates, industry leaders and academics. It should be noted that three of our respondents — **George Nichols**, **Dave Snyder** and **Robert Hunter** — have participated in all three special issues. We thank them for their continued support.

What strikes us about these 15 responses is their diversity. From the warning by **Congressman Earl Pomeroy** that more complex products don't necessarily translate into more "innovative" products to **Dr. Robert Hartwig's** call for more oversight of insurer risk management functions, the lessons are far-reaching and thought provoking.

Please take the time to review the responses from our esteemed contributors. The extent to which state insurance regulators absorb and respond to these lessons could very well shape this nation's insurance regulatory framework for years to come.

* * *

**A FINAL NOTE:** As many of you know, **Scott Hoober** passed away in October. A former staff member of the Fed, Scott brought his unique insights to the financial services industry to the pages of *The Regulator* as its featured correspondent for nearly two decades. In fact, Scott's final *Regulator* article (and one of his best) focused on credit default swaps and the subprime mortgage crisis. It appeared in our March 2008 issue. Scott also participated in our 1999 and 2004 special issues and his input for this issue was sorely missed. A full obituary appears on page 18. — *W.C.*

# Congressman Earl Pomeroy

# Lessons for insurance regulators from the economic crisis

Twenty-five years ago I attended my first NAIC meeting as a green, newly elected Insurance Commissioner. The urgent topic of that December1984 meeting was the fall of Baldwin-United.

As a newcomer to financial regulation, the case struck me as very curious. Brash, hotshot 'talent' had taken over a venerable piano manufacturer, Baldwin Piano. They transformed it into a national financial services powerhouse marked by innovation and rapid growth until the whole enterprise collapsed under the weight of bad numbers flowing from an inherently flawed business plan.

Whether by incompetence or fraud, it was a failure and the smart guys behind the whole venture didn't look so smart any longer.

At the time I remember thinking that I'd probably never see a mess like that again. Little did I know that our economy was about to double down on the financial services sector in a heedless embrace of innovation and growth with regulators at the federal level politely stepping aside so as to not get in the way.

Although my vantage point on all this moved from being a state regulator to a federal legislator, I have watched the Baldwin-United phenomenon repeat itself again and again and again. Smart guys with new schemes and impressive short-term performance records ultimately become undone.

The consequences, however, became ever more serious as the global markets widely accepted non-underwritten mortgage loan securitization and companies gobbled up debt on the pretense the exposure was minimized through astonishing reliance on unregulated credit default swaps.

It is tragic so much wealth evaporated, so many jobs were lost, and so many lives were disrupted as a consequence of marketplace foolishness and fraud, while regulatory oversight completely failed.

How do we tame these inevitable market forces of recklessness and greed?

Surely the lessons learned from Baldwin to Bear Stearns and beyond must instruct the creation of additional public protections which definitively end blind faith as regulatory strategy. The era of laissez-faire capitalism is over.

Regulators must reinforce the tried and true principles of solvency oversight and fortify them with these two wise principles I have learned along the way.

1. Leverage is not capital
2. Complexity is not innovation

In the history of financial regulation in our country, there have been periodic revisions in order to restore public safeguards when marketplace evolution has rendered the old protections insufficient or even meaningless.

As Congress grinds away at erecting new protections, in the well led effort by House Chairman Barney Frank, it is imperative we take these painfully learned lessons, and incorporate them at the heart of the regulatory regimes to follow.

This effort will be strengthened by broad input by the regulator and regulated alike at all levels of regulation. I am very hopeful that we will produce a range of safeguards that will keep future Baldwins in the piano business and not wreaking havoc across the financial marketplace.

**Earl Pomeroy is North Dakota's sole member of the U.S. House of Representatives. He is also a former North Dakota Insurance Commissioner and NAIC President.**

# Robert Hunter

Even former Fed Chairman Alan Greenspan has recognized that market forces alone do not protect consumers. Regulators need to identify and stop destructive competition to protect consumers. This is something consumer groups have been warning the NAIC and state commissioners about for years, and by now even the most ardent free-marketeers should recognize the importance of meaningful financial services regulation.

Price regulation is particularly crucial in insurance classification. Freeing insurers to use whatever classes they choose, even those with no logical connection to risk (such as credit scoring), has harmed American consumers. As peoples' credit scores deteriorate in this sour economy for reasons clearly beyond their control, how can regulators allow insurers to raise prices based on such scores?

The life insurance industry narrowly missed a major meltdown and is not yet entirely out of the woods. The lesson here is that conservative capital requirements and investment restrictions have well served insurance consumers even though life insurers continue to seek to loosen restrictions. Regulators must resist efforts by life insurers to weaken standards as the crisis eases. Strong uniform accounting standards are essential to the well-being of the industry and consumers.

States should also end the embarrassing custom of granting permitted practices to individual insurers which circumvent existing rules and regulations. Permitted practices are usually initiated by regulators in an insurer's home state in response to political pressure and only serve to weaken consumer protection.

**Be Aware**

AIG has shown that insurance regulators, like all financial regulators, must be aware of the risks posed by all of an insurer's affiliates and subsidiaries. It is not enough to look at the safety of the insurance affiliates themselves when an obscure offshore operation can bring down the entire company or holding company structure.

Moreover, regulators should not allow products to be underwritten that they don't fully understand themselves. In the AIG case, insurance regulators determined that credit default swaps were not insurance products and the feds turned a blind eye to them. How many of those in the regulatory process actually understood these instruments?

Here's a timely test for state insurance regulators: When Wall Street begins knocking on your doors with plans to securitize life settlements, run for the hills. They will blithely destroy the life insurance business, just as they nearly destroyed the banking business, in exchange for turning a good, short-term profit.

**Embrace the Feds?**

Regulators should admit the obvious — there are systemic risks in the business of insurance and that state insurance regulators need to embrace federal safety and soundness regulation to control such risk.

Regulators should also admit that their oversight of insurance closely related to credit transactions has failed miserably. These lines (credit, title, forced-placed insurance, etc.) are almost always a huge rip-off for consumers, particularly in hard economic times. Regulators should put protecting consumers ahead of protecting their turf and agree that the new federal Consumer Financial Protection Agency should be tasked to regulate these lines.

Lastly, although the federal government's role should be expanded, it would be a mistake to give a regulated company the ability to choose the regulatory body that oversees it. The banking industry has shown the havoc that "regulator shopping" can wreak on the marketplace. Regulators should join consumers to convince Congress that an Optional Federal Charter (OFC) approach to insurance regulation is a bad idea.

**J. Robert Hunter is Director of Insurance of the Consumer Federation of America.**

# Terri Vaughan

Since returning to the world of the NAIC in February, I have been impressed with the changes that have taken place while I was away. There is energy in this organization that excites me, there is a synergy and engagement among the members that makes many things possible in what I believe is an historic time.

While our system has by all accounts been a success, it is simply good practice to periodically take a comprehensive look at what you are doing. Our last comprehensive review, which took place 20 years ago, resulted in the Solvency Policing Agenda. The current financial crisis and global developments in prudential supervision and international standard-setting make this an appropriate time to undertake another such review.

## Lessons for insurance regulators from the economic crisis

What are the lessons of the financial crisis, what can we learn from what other countries are doing, how well does our system comport with emerging global standards, and what are the implications of emerging international financial reporting standards for U.S. insurance regulation? These are good questions, and questions we are working to answer.

The NAIC's Solvency Modernization Initiative (SMI) Task Force is leading the effort, supported by a number of working groups, and the Center for Insurance Policy and Research (CIPR) team is taking the lead in providing much of the background work that the SMI Task Force will need to reach its conclusions. We are doing deep dives into the systems in other countries and into international standards.

We are more formally articulating the principles underlying our current system and the structure of our current system around those principles. We are looking at how we can marry other data – particularly data on investments – with the information in our NAIC financial database to better understand the emerging risks in the insurance industry. Finally, we will be starting a work stream around systemic risk to better understand the nature of systemic risk in the insurance industry.

The SMI is one of the most exciting and important efforts underway at the NAIC right now. A hallmark of our system over the years has been the process of continuous improvement and the consensus-driven way that we develop those improvements at the NAIC.

In 1989, the NAIC announced the Solvency Policing Agenda. In implementing that agenda, state regulators took major steps to improve solvency regulation – increasing our focus on risk, creating a risk-based capital system, creating the accreditation program, and increasing the intensity of our analysis and examination processes. Further improvements have occurred over the years – codification of our accounting system, further changes in our examination system, increased coordination in oversight of insurance groups through the lead state concept, and other improvements.

Through the collective wisdom of its members, the NAIC has built a system of financial regulation that is risk-focused, comprehensive, and, most importantly, successful.

These are indeed historic times. Fifty years from now, people will be looking to this time to try to understand why we did what we did. We have a great opportunity, and it would be a tragedy to waste it. I know I speak for myself, and I believe I speak for the NAIC when I encourage everyone to join us in seizing this moment in history to make our system the best that it can be.

**Dr. Therese Vaughan is NAIC's Chief Executive Officer.**

# Robert Rusbuldt

The current economic crisis has reinforced the longstanding position of the Independent Insurance Agents & Brokers of America (the Big "I") in support of the state system of insurance regulation. This system has functioned with distinction throughout the economic crisis and continues to outperform its federal counterparts in other financial sectors. State insurance regulators should be applauded for keeping the insurance industry stable and Congress should concentrate on targeted reform of the state regulatory system in the limited areas where needed and not impose unnecessary sweeping reform by establishing federal regulation.

State insurance regulation has a long and stable track record of accomplishments, particularly in the areas of solvency regulation and consumer protection, but its strengths have never been more apparent than in the past year. As problems have been raised and discrepancies identified regarding regulatory entities of other financial services, state insurance regulators have admirably and effectively ensured that insurers are solvent, claims are paid, and consumers are protected.

Of course, that doesn't mean that everything is perfect, because there are areas that would benefit from targeted federal legislative action. An example is the "National Association of Registered Agents and Brokers Reform Act of 2009" (NARAB II), a well-crafted bill that would provide for streamlined nonresident insurance agent and broker licensing while preserving state insurance regulation and consumer protections. The Big "I" is optimistic that the 111th Congress will pass this pragmatic reform bill.

> "*Those who continue to push for federal regulation of the industry despite the failures at the federal level . . . are beating a dead horse.*"

Those who continue to push for federal regulation of the industry despite the failures at the federal level to regulate other financial services are beating a dead horse. Instead of trying to fix what isn't broken, the White House and Congress should look to the state regulation of insurance system as a model for other sectors. Some have mistakenly grouped insurance with the financial service markets that actually caused the crisis. As some politicians call for stronger and more efficient regulation, the insurance market is threatened with having to pay for the deficiencies of others when insurance regulation should instead be viewed as the model for how to effectively supervise a market.

The evidence fails to support federal regulation being more effective than state-based regulation. Whether it's commercial banks, investment firms, or international holding companies (like AIG), historically, problems follow when the federal government oversees the financial services markets. The financial industry sectors at the center of the nation's financial crisis were primarily regulated by the federal government. Even the S&L scandal of the 1980s, which cost billions to clean up, was also "being watched" by the federal government.

Most everyone agrees that state insurance regulators are not to blame for the financial troubles of the past year. As the stability of the insurance market demonstrates, state regulators are doing their jobs of actively monitoring U.S. insurance entities for potential financial trouble by using a variety of tools to help insurers navigate through choppy market waters. Congress should not further disrupt these waters by scrapping such an effective regulatory system and replacing it with an unproven, unnecessary regime that would be harmful to consumers. By acting in a targeted way via federal "tools," Congress can streamline state regulation while maintaining its inherent strengths.

**Robert A. Rusbuldt is president and CEO of the Independent Insurance Agents & Brokers of America.**

# Wendell Potter

The current economic crisis teaches insurance regulators several key lessons to prevent a wholesale health care meltdown in America. Much like the financial sector, the health insurance sector has made short-term gains its priority rather than the health and well-being of its customers.

As a result, private insurance fails to meet the needs of Americans and is increasingly unaffordable and unsustainable. Insurers have driven up premiums and out-of-pocket costs, putting consumers at financial risk if they need costly health care services or forcing them to go without needed care.

For health care reform to work there must be the type of federal oversight and consumer protections required of the financial sector under the proposed Consumer Financial Protection Agency (CFPA). The creation of the Health Choices Administration (HCA), as outlined in proposed HR 3200 (a.k.a. America's Affordable Health Choices Act of 2009), is critical.

As a supplement to state oversight, federal oversight and enforcement should help ensure uniform enforcement of new federal consumer protection standards. Together they can best promote transparency, simplicity, fairness, accountability, and access to health care services. State regulators and attorneys general would be given authority to enforce federal standards alongside federal regulators. Federal law would only preempt weaker state laws.

Several studies show that many states lack requisite resources and authority to oversee insurers. As a result, many states lack good consumer protection laws and even those with good laws often do not have the staff to focus on anything but the solvency of the insurers they regulate. Complementary federal oversight and enforcement protects Americans in states without the wherewithal to enforce the laws. It also provides the nation with a macro picture of our health care system that can uncover emerging trends among states.

The federal agency must have full authority to require data reporting and greater transparency from the insurers. It will help standardize and rationalize data and improve our health care system. Currently, precious little data is available to compare insurance plans though they all are very different.

A range of data from the insurers is essential if the government is to ensure plans are not discriminating against people with costly conditions and to educate Americans about differences among health plans. Data that should be available for government review include enrollment applications, retention rates, disenrollment rates, rating practices at issue and renewal, claims payment practices, and utilization review activities.

In addition, the federal agency will need to establish measures of medical debt, uncompensated care, delayed or foregone care, balance billing, consumer cost-sharing, and to monitor plans to determine coverage adequacy. Finally, plans will need to report in detail on medical loss ratios and claims data so that the government can effectively operate risk adjustment systems and/or public reinsurance.

Like the proposed Consumer Financial Protection Agency, the Health Choices Administration would operate an ombudsman program to provide consumer information and help resolve problems and complaints. The HCA would also have the power to set standards that lead companies to compete by offering products that consumers actually want — and understand. Health insurers will no longer be able to offer policies with pages of fine print that no one can figure out.

The HCA mission should be analogous to that of the CFPA as described by Treasury Secretary Timothy Geithner: "This agency will have one mission — to protect consumers — and have the authority and accountability to make sure that consumer-protection regulations are written fairly and enforced vigorously."

**Wendell Potter is a Senior Fellow on Health Care for the Center for Media and Democracy. He was formerly CIGNA's Vice President of Corporate Communications.**

# Joel Ario

I had a unique vantage point on the economic crisis as the lead regulator of AIG's commercial property and casualty companies. The crisis started early for AIG, when its formidable insurance operation was brought to its knees by what Ben Bernanke called "unconscionable" risk-taking in the largely unregulated credit default swap market.

When AIG was forced to accept an $85 billion federal bailout last September, some were quick to point their fingers at state-based insurance regulation. In fact, we now know that the insurance subsidiaries of AIG, including 71 U.S.-based companies, are among its strongest assets and continue to deliver solid value to policyholders.

The jury is still out on whether the federal government will be fully repaid, and whether the AIG brand will survive or fade away through a combination of sales and IPOs. But it is not too early to consider how AIG became the poster child for systemic risk and what lessons can be drawn for improving financial regulation.

> *"It is critical that any reforms reinforce the principle that insurance assets are to be conservatively managed for the benefit of policyholders."*

**Regulation is beneficial even in sophisticated markets.** AIG got into trouble because an obscure entity called Financial Products bet the farm on residential mortgages and could not cover its bets with counterparties who hedged their risk through credit default swaps. Had Congress not deregulated the credit derivative market in 1999, there would have been regulatory oversight and presumably some effective action to prevent Financial Products from putting the entire financial system at risk by taking on obligations AIG could not meet when the real estate market tanked.

**Systemic risk must be addressed but cases should be limited.** AIG posed systemic risk because many of the world's leading financial institutions would have lost billions if AIG had collapsed. The key issue was not AIG's size, but its connectedness to these counterparties. We need an effective system for identifying and managing entities with this kind of connectedness, but there should be few such cases as evidenced by the fact that we have not seen any repeats of the AIG story.

**Insurance regulation must protect policyholders.** The insurance industry has weathered the crisis better than others because insurance regulation focuses on protecting policyholders. It may not be practical to repeal laws allowing insurance risk to be combined with other types of financial risk under a holding company structure, but it is critical that any reforms reinforce the principle that insurance assets are to be conservatively managed for the benefit of policyholders and not used to bail out other subsidiaries.

**Checks and balances work better than single regulators.** As debate continues on how to manage systemic risk and modernize financial regulation, Congress should note the collegial approach used by state insurance regulators to ensure that there are multiple eyes on any large company, so that the system relies more on checks and balances than on any single regulator to always get it right.

Joel Ario is Commissioner of the Pennsylvania Insurance Department.

# Robert Hartwig

Regulators of financial institutions worldwide have many lessons to learn from the global financial crisis. The ultimate lesson of the crisis is that adherence to the basic principles of risk management matters. Institutions with sound risk management practices have emerged as clear winners—increasing market share at the expense of weakened competitors and gaining the confidence of consumers and investors.

This lesson is as true in insurance as it is in banking. It is no accident that the basic function of insurance—the transfer of risk from client to insurer—continued uninterrupted throughout the entirety of the crisis. The continuity of insurer operations even during the darkest days of the crisis is directly attributable to generally superior risk management practices employed by the vast majority of insurers. Specifically, the five essential risk management practices and principles that distinguished the performance of insurers from that of banks during the crisis are the following:

**Lessons for insurance regulators from the economic crisis**

- **Strong Emphasis on Risk-Based Pricing and Underwriting**: Insurers make every effort to match risk to price and limit their overall exposure to risk. Many banks sought to maximize revenues and fees and ultimately disregarded risk.

- **Maintaining the Relationship Between Underwriting and Risk Bearing**: Insurers and reinsurers always maintain substantial stakes in the business they underwrite. In other words, they keep "skin in the game." Many banks substantially or entirely severed the link between underwriting and risk bearing through excessive use of securitization, leaving them with little or no financial stake in the outcome of their business. As a result, underwriting standards became predictably lax with predictably catastrophic outcomes in a classic textbook manifestation of moral hazard.

- **Low Leverage**: Insurers do not rely on borrowed money to underwrite insurance or to pay claims. Consequently, insurers did not suffer from credit or liquidity problems during the crisis. Banks, in contrast, were highly leveraged with many holding between $15 and $30 in borrowed funds for every $1 they held in capital, leaving them vulnerable to credit market disruptions.

- **Conservative Investment Philosophy**: While no institutional investor was completely immune to plunging asset values and record volatility during the current crisis, most insurers fared better than their banking brethren due to relatively low equity allocations in their portfolios and relatively few exotic credit instruments.

- **Operating Firmly Within a Regulatory Structure**: The entirety of an insurance enterprise's operations are under the purview of regulators (whether at the state level as in the United States or the federal level as in Europe). Elsewhere in the financial system a rapidly increasing proportion of the liquidity, credit and credit guarantees flowing through international financial markets was unregulated, including derivate products such as credit default swaps. These unregulated market segments were substantively responsible for increasing the scope and severity of the crisis.

The ultimate blame for the financial crisis lies squarely with those financial institutions whose risk management practices were weak, ignored or both. Irrespective of the form of regulation, financial industry regulators must focus additional attention on the quality and practice of risk management in order to avert future crises.

**Dr. Robert Hartwig is President of the Insurance Information Institute.**

# Lessons for insurance regulators from the economic crisis

## Kevin Foley

The lesson? Insurance works. It works well as a linchpin of the vast and complex American economy. Through one of the worst economic periods in our history, insurance claims of every kind are being paid with efficiency and dispatch. Amidst massive layoffs, millions of mortgage foreclosures and financial credit failures on a grand scale, the resilience of the insurance business is just cause for celebration.

> ***"Through one of the worst economic periods in our history, insurance claims of every kind are being paid with efficiency and dispatch."***

You would think a business that had proven its strength and value during such turbulence would find ways to shout it out so citizens might appreciate the fact. But then the insurance industry has never been good at straightforward public communication. Besides, to declare success might promote the dangerous idea that regulation (state regulation!) actually works to the benefit of all stakeholders. We wouldn't want that notion taking hold in the public mind and worse, in Congress, would we?

Of course, the present state of affairs is complicated and full of contradictions. Many insurers have found themselves seriously threatened by investments that on second thought weren't prudent. And then there is AIG. Talk about a black eye for the industry. Here is a global insurance icon failing utterly in its mandate to manage risk properly on behalf of policyholders and shareholders. Anyone who's ever worked in the business can relate to the chagrin and frustration felt by most AIG employees at the reckless performance of a tiny rogue unit within its vast corporate network and the subsequent disgrace of an unprecedented rescue by taxpayers.

The credit default swaps, sold like heroin to addicts, were called insurance, even though everyone (company executives, the "sophisticated" buyers, stock analysts, as well as state and federal regulators) knew they weren't really insurance, which would have meant they had to be adequately capitalized for the risk taken; it was just convenient to call them insurance for everyone's very temporary peace of mind.

My friend Terry Lennon, legendary retired Chief of the New York State Insurance Department's Life Insurance Bureau, likes to refer people to the tremendous growth of the insurance business from the end of World War II to the present. He points out that companies large and small have never stopped complaining about the burden of regulation despite the more or less steady success story.

Of course, insurance — real, regulated insurance — doesn't offer the opportunity for unfettered wealth that excessively leveraged speculation does. And now that we have had the near-death experience of the most recent meltdown, perhaps we can admit loudly that's not a bad thing.

Kevin Foley, a former regulator and insurance executive, is co-founder of Foley/Myers Communications.

# Sen. James Seward

As the notable U.S. Senator and 1836 presidential Whig candidate Hugh White said, "Mistakes are lessons of wisdom. The past cannot be changed. The future is yet in your power." The financial crisis has shown state lawmakers not only what we need to do better, but what we have done well. State insurance regulation has proven itself. The National Conference of Insurance Legislators (NCOIL) believes now — more than ever — that states are the appropriate insurance regulators and protectors of consumers.

**State Insurance Regulation Works Well**

The stability of U.S. insurance companies, as compared with those of other financial sectors, demonstrates the effectiveness of our state laws and regulations. Already in 2009 the U.S. has seen more than 100 bank failures, far beyond what we've witnessed in the insurance industry.

State insurance regulation has cultivated some of the largest markets in the world. In fact, 28 of the world's 50 largest insurance markets are individual states and the total U.S. insurance market is larger than the world's second, third, and fourth largest markets combined.

**No Need to Go Federal**

State regulation should not be drawn into a broader review of financial services reform because of failures tied to federally regulated — or deregulated — financial giants like Lehman Brothers and AIG. If anything, it should serve as an example for those looking for solutions to the current problems. We hope that other state officials, including the NAIC, will heed this lesson and not sacrifice state authority for a seat at the federal table.

**Federal Regulation is Counterproductive**

Federal authority would lessen good regulation that has kept insurance companies from bad business practices. Insurance consumers would fall prey to new bureaucracies and dual, conflicting regulations. The current crisis, the 1980s saving and loan fiasco, ERISA, Medicare Part D, Medicare Advantage, and FEMA demonstrate the shortcomings of federal intervention. Although the size of recent taxpayer bailouts has proven that federal regulation is not a good model for reform, an optional federal charter and a federal insurance office would lead us down that path.

**Modernization is Necessary**

The financial market has spurred ongoing state modernization efforts, including speed-to-market, rate and form modernization, uniform agent and company licensing, and market conduct reform. While we do realize the need to modernize, we should be wary of relaxing standards that have served us well, such as strong capital, surplus, and reserve requirements. And while certain global arguments have validity, we must be careful to weigh each on its own merit.

> *"Regulators, as well as the regulated, must shed their protectionist natures and share data across jurisdictions."*

**Communication is Paramount**

It is clear that in order to see the big picture in financial services, regulators must access and disseminate a broad spectrum of financial information. Regulators, as well as the regulated, must shed their protectionist natures and share data across jurisdictions. While NCOIL does not support a super or *űber* regulator of systemic risk, we acknowledge that in order for this to work, state and federal officials must be on equal footing and the process must be transparent.

**Summary**

We at NCOIL are optimistic that we can positively impact the future through lessons learned from this unfortunate turn of events. We believe that it makes inherent sense to build on — not tear down — a system that has helped U.S. insurance companies weather this economic storm.

**State Senator James Seward (R-NY) is President of the National Conference of Insurance Legislators.**

# Etti Baranoff

The saying "crisis breeds change" is most appropriate to describe the evolution of the 150+ year history of U.S. insurance regulation. Crises and catastrophes have shaped the current status of regulation.

The first decade of this century has provided a laboratory in which all types of catastrophes — from 9/11 to the natural disasters of 2005 to the global financial crisis of 2008-2009 — can be examined. The nature and scope of these catastrophes have required greater intervention by the federal government in the insurance arena.

On the life insurance side, the increased use of sophisticated instruments such as asset-backed securities and mortgage-backed securities, along with new products such as variable annuities with guarantees, brought a capital crisis upon many large U.S. insurers. The fact that some life insurers were in line for TARP money is an indication of the inevitability of federal government involvement in insurance regulation.

On the property/casualty side, insurers were exposed to the traumas of man-made and natural catastrophes. Despite the accepted notion that natural catastrophes have regional focus, the 2005 hurricane season could not be regarded as regional in its impact. While 9/11 brought the Terrorism Risk Insurance Act (TRIA) and involvement of the federal government in insurance regulation, Hurricane Katrina, Rita and Wilma kept the feds involved as well.

The sheer size, impact and acceleration of such calamities led international players who participated in recent International Insurance Society seminars to question how state-by-state insurance regulation can be sustained. They also expressed concern about the complexity and lack of uniformity of the state regulatory system in a world that is increasingly regarded as one global village.

The current nature of U.S. insurance regulation is designed to cater to regional problems. The handling of catastrophes during the first decade of this century illustrates that transition is underway. Insurance regulation in the U.S. today is a *de facto* dual system as demonstrated by federal involvement with AIG and other insurers. Such a dual system poses great dangers and has the makings of a compromised safety net for insurance consumers. Lack of accountability fosters risky undertakings by greedy managers without regulatory oversight. Such was the case with the credit default swaps that would have taken AIG down had not taxpayers' money resurrected the company.

> ***"Insurance regulation in the U.S. today is a de facto dual system as demonstrated by federal involvement with AIG and other insurers."***

The crises of this decade teach us that regulation today requires massive resources and sophistication on par with the players in the insurance markets. Without such resources, the accelerated innovations combined with the convergence of insurance and the financial markets will expose consumers to new risks without the necessary regulatory safety net for sustainability.

**Dr. Etti Baranoff is the Associate Professor of Risk, Insurance and Finance at the Virginia Commonwealth University, School of Business.**

# David Snyder

## Lessons for insurance regulators from the economic crisis

The financial turmoil has given rise to many proposals for more regulation, and more layers of regulation. But recent history shows that a multiplicity of regulation and regulators does not assure an outcome in the public interest. In fact, property and casualty insurers continue to perform well, and can be held back as much by unproductive regulation as anything else.

Poor regulation reduces insurers' ability to fully contribute to the achievement of the balanced and sustainable economic growth set forth as the highest goal by the world's leaders in recent G-20 statements. Thus, the real lesson of the crisis is that U.S. and international insurance regulation needs to be effective, efficient and supportive of open and competitive insurance markets.

Effective regulation is focused on the core public policy of assuring solvency, as opposed to regulation that substitutes political judgment for functions that are far better regulated by the market, including what insurance forms are used and what prices are charged. Unregulated or lightly regulated and risky noninsurance financial products should be carefully scrutinized.

Efficient regulation accomplishes desirable public goals but does so at the least cost, thereby freeing insurers' resources for re-investment in operations, providing more coverage and allowing for more public advocacy for loss prevention. Regulatory efficiency is now particularly important for U.S. insurers operating in an increasingly competitive global marketplace.

The OECD Insurance and Private Pension Committee's work on documenting best regulatory practices, including rigorous cost/benefit analyses as a predicate to regulation, is very important. In addition, duplicative and even conflicting regulatory mandates within the U.S. and on the global level should be avoided in favor of uniform standards and regulation, applied, to the extent possible, by one highly sophisticated and competent regulator using pro-competitive regulatory principles.

Pro-competitive regulation provides for open markets and encourages competition and the investment of domestic and foreign capital. Such regulation maximizes the potential societal contributions of insurers, which include: financially restoring individuals and businesses after loss, providing capital for infrastructure development for roads, schools and other public works, assisting economic development and business activity, and improving safety through financial incentives and public policy advocacy.

International barriers to U.S. property and casualty insurers, alone, annually cost them $40 billion in premiums and related jobs and also deny millions of people the societal benefits of that insurance.

If allowed through effective, efficient and pro-competitive regulation, insurers can better support the global goal of the balanced, sustainable economic growth agreed to by the world's leaders as recently expressed through G-20 statements.

So, the main lesson of the current crisis for regulators is that property and casualty insurers are not in need of more unproductive regulation. Instead, they need regulation which is effective at maintaining solvency, efficient, to prevent waste, and pro-competitive, to maximize the potential contribution insurers can make to improve the quality of life and support sustainable economic growth.

**David Snyder is Vice President and Associate General Counsel, Public Policy, for the American Insurance Association (AIA).**

# Sean Dilweg

The current economic crisis has shown us that weaknesses in federal regulatory oversight were allowed to permeate the financial system, creating conditions that encouraged risky investment choices on the part of financial services companies. The securitization of subprime mortgages allowed regional downturns in the housing market to have a national impact.

Here in Wisconsin, we saw firsthand how these risky investments, dependent on the false paradigm of an expanding and growing housing market, exposed companies to trillions of dollars of risk.

While many banks were brought to near collapse, insurance companies maintained adequate reserves to pay claims. Strict and uniform state solvency requirements kept insurers out of trouble. It is important to remind policymakers of this as they attempt financial regulatory reform.

State-based insurance regulation did not create a "too big to fail" environment in the insurance marketplace. There are no insurance companies that present a systemic risk just as there are no insurers that require federal assistance due to the failure of a state-regulated function. With policyholder protection as the primary insurance regulatory function, state insurance regulators have shown that a proper focus will achieve successful results, even under dire economic conditions.

Contrasted with an unfocused federal system that invites regulatory arbitrage, one wonders why regulatory reformers don't try to learn from state insurance regulators instead of trying to create an additional layer of bureaucracy.

Insurance regulators are reevaluating some of their own presumptions. The economic crisis has caused state regulators to take a look at how we view asset valuations. Additionally, as regulators we need to be sure that the financial information we use provides a realistic assessment of all insurer investment activities.

It is not enough for regulators to rely on credit rating agency assessments. These ratings are prepared for purposes other than regulatory oversight. State insurance regulators need to look beyond the rating agencies and make judgments about investments that reflect the underlying goal of policyholder protection.

**Sean Dilweg is the Wisconsin Commissioner of Insurance.**

## IRES Chapter News

**VIRGINIA** — In the Virginia Chapter's quarterly meeting last summer, examiners from the Virginia Bureau of Insurance summarized changes to Virginia insurance law. Due to the large number of attendees (50), the session was held twice. The presenters were **George Lyle, Amanda McCauley, Debbie Seay, Jim Young, Elsie Andy, Al Battle, Yolanda Tennyson, Florence Morris**, and **Mary Ann Mason**. The Chapter also has two new officers: Vice President **George Lyle** and Secretary **Bryan Wachter**. A follow-up meeting included a discussion of current regulatory issues.
— *Andrea Baytop; andrea.baytop@scc.virginia.gov*

**LOUISIANA** The Louisiana State Chapter's August meeting featured **Alison Jones**, Director of the Louisiana Health Care Commission presenting to 49 attendees. Ms. Jones discussed insurance legislation enacted in 2009. Out of the 22 bills initiated by the Louisiana Department, 21 were enacted.

At the September meeting, **Percy P. McCraney**, Deputy General Counsel and Assistant Secretary of Amerisafe, Inc., discussed, "When 'No' Means 'Yes': Navigating the Maze of Multi-State, Multi-Carrier Regulatory Compliance." Twenty-seven people attended.
— *Larry Hawkins; lhawkins@ldi.state.la.us*

# George Nichols

The most important lesson that I learned as a regulator was that "consumer protection" is all about ensuring that a company can pay a consumer's claim. A regulator's ability to deliver on this protection requires prudent and conservative financial management by insurance executives and strong effective solvency oversight by insurance departments.

As a nonfinancial guy, my respect continues to grow for the financial and risk management experts at both companies and insurance departments who make the insurance industry strong so that insurers can deliver on paying the claim.

> ***"Proposals for regulatory modernization should not throw out what works in favor of new and untested ideas."***

In the wake of the economic crisis, regulators and the regulated continue to review the best ways to ensure the stability of the financial system — on both domestic and international levels. In the U.S., our state regulators are looking at capital adequacy issues, while there are pending proposals for the federal government to take a more active role in stemming the negative outcomes of systemic risk.

On the global front, national leaders and financial supervisors are reviewing potential best practices to promote stronger international financial architecture. All efforts aim to bolster the financial system to withstand the increasing pressures of interconnected operations and global demands.

It is important not to stray from the fundamentals. For insurance, one of the most important points underscored by the crisis is the need to continue to ensure sound, practical solvency standards. Insurance customers pay for a promise to provide for their financial security in the future.

A number of jurisdictions, including the U.S., are looking toward solvency modernization, but we need to keep in mind that one regime will not fit the needs of all. Solvency regulation should be calibrated to best fit the dynamics of individual markets.

A few other "lessons" learned from the crisis — insurance is a different business from banking. Regulatory responses must be cognizant of this fact and this unique insurance perspective should be incorporated into the directives of emerging global financial standards. Investment strategies must align with the liabilities of insurance, but supervision should not adversely restrict integral capital flows vital to economic growth.

Recognizing the current crisis of confidence in the market, regulation should be cautious not to stifle the ability of insurers to provide innovative, financially secure solutions to consumers. Proposals for regulatory modernization should not throw out what works in favor of new and untested ideas.

Our 50-state regulatory system can be inefficient by nature, but it was nonetheless effective in maintaining the all-important solvency of the insurance sector before and during the crisis.

Improvements can and should be made by regulators as an ongoing process. Market forces and conditions change and regulation must be responsive. We should build upon the necessary fundamental premises that underpin our sector, understand and draw from evolving best practices and transition regulatory systems that continue to maintain solvency and protect consumers.

At the end of the day, the most important thing for the consumer is — can you pay the claim? If we stay grounded in the fundamentals, the answer will always be yes.

**George Nichols is Senior Vice President of the New York Life Insurance Company. Mr. Nichols is a former Kentucky Insurance Commissioner and past NAIC President.**

# Sandy Praeger

While the economic downturn of 2008 and 2009 has triggered a closer inspection of the financial services industry in the United States, we as state insurance department regulators are confident that our responses to market conditions and public perception have been clear.

Had the portions of the industry that caused the major economic distress been under control of state regulators, it's certain that we could have averted many problems. State regulators, through the nuts-and-bolts processes we maintain for solvency and consumer protections, have the ability to spot problems in individual companies and make sure those scenarios are passed on to our fellow regulators.

Our National Association of Insurance Commissioners provides us the ability to network with colleagues throughout the country. We can share with other state regulators our specific concerns regarding both companies and consumers. Daily department-to-department input staves off many problems that could escalate to national situations.

The 2009 economic situation has made us keenly aware of how important our daily oversight is. In our licensing reviews, solvency issues, consumer protection and fraud investigations, we are vigilant in making sure the insurance industry functions properly. We continue to work for improvement in our consumer protections.

With the economic downturn, our mission to educate consumers and advocate for them has increased — as a natural part of our departments' missions. When it's necessary to intervene with companies on behalf of their policyholders, our departments have enhanced their role as a voice for consumer claims and concerns.

My office, for example, is on its way to a possible annual record for consumer recoveries. Our anti-fraud division, as well as anti-fraud organizations throughout the country, have an increasing workload in harder economic times.

The national economic concerns also point to the reality that state regulation of insurance is the best possible scenario for continued consumer confidence. With state departments, you get a quicker, more reasoned, personal response; we know that consumers on the phone are residents of our area. We are connected to them in many ways. If current legislation proposed at the federal level becomes law, however, consumers might find themselves having to leave messages about insurance concerns on a toll-free line to a federal agency.

I know who consumers would rather talk to.

These are many of the key lessons that regulators can point to as we all work through the economic problems our nation faces. With more than 130 years of service to U.S. consumers, we know we have the expertise in place to continue dealing responsively with national issues through our interconnected framework of insurance regulation.

Sandy Praeger is Kansas Commissioner of Insurance and a former NAIC President.

## LOOKING FORWARD TO 2010 IRES CDS

In addition to great CDS sessions in New Mexico in 2010, did you know:

- The longest aerial tram is in Albuquerque with great views and dining at the top and bottom?
- Route 66 runs through Albuquerque?
- Petroglyph National Monument is just outside of Albuquerque?
- Trolleys are available to Old Town for shopping, dining, museums, and historical sites?
- Hot air balloon rides are available at times other than the Balloon Fiesta in October in Albuquerque?

For additional information, check out the links at *www.go-ires.org*.

# Dennis Shoop

First and foremost, I believe the current economic crisis has helped reinforce the value of state regulation. While many financial institutions faced unprecedented challenges these past few years, insurers generally were able to avoid many of the risky investments causing such turmoil. The current process of state solvency monitoring seemed to work as anticipated by helping mitigate the damages to insurance companies and consumers. Given the widespread problems associated with other financial services sectors, the insurance industry withstood the storm far better than most.

That is not to say that the current solvency monitoring system should not be improved. As in prior times, insurance regulators will monitor the industry and revise procedures to better protect consumers. Lessons learned from this experience will allow regulators to strengthen the existing nationwide financial accreditation program. The current system results from regulators assessing the market risks and factoring in prior issues/problems to maintain a cohesive program that continues to show positive results.

> ***"Many of the problems of the current crisis occurred because people invested in products they simply didn't understand."***

One area that continues to cause concern is how difficult certain complex insurance/investment products are to understand. Insurance consumers find it extremely difficult to understand all aspects of these products. They rely on presentations by their agents or brokers. As we've seen far too often, such presentations do not always parallel contractual provisions. Many of the problems of the current crisis occurred because people invested in products they simply didn't understand. Such actions are usually a prescription for disaster.

Consumer outreach and an effective complaint-handling process are important components of all insurance departments, as they need to be. As the baby boomer generation ages, more and more consumers struggle to understand insurance products ostensibly designed to meet their needs. How many of you have advised parents or other family members on insurance products or terminology? It can be a daunting experience to try to explain the difference between an HMO and a PPO, or to describe an equity-indexed product, or assess the pros and cons of Medicare Part D prescription drug benefits. Even for longtime members of the insurance community, it's a challenge.

Regardless of the changes to the marketplace, consumers will always need to understand their insurance options and how choosing such options will impact their coverages. A challenge for all regulators is building an effective outreach program through which help can be offered to the maximum number of consumers and information can be provided to them in a timely and straightforward manner. Ultimately, a more informed consumer is a more satisfied customer.

*Dennis Shoop is President of IRES.*

## Welcome, new IRES members!

Edward J. Bannister, DC

Dennis D. Forrester, Unaffiliated

Geraldine Hato, Netherlands Antilles

Ria J. Hermina-Lemmers, Netherlands Antilles

Kimberlee A. Hewitt, MT

Candace B. Reese, MCM, DE

Roger Stewart, MCM, Unaffiliated

Debra M. Webb, MCM, IN

# Scott Hoober: 1943-2009

*The Regulator* staff and the entire IRES family is saddened to report the death of Scott Hoober of Kansas City, after an 18-month battle with brain tumors and lung cancer.

Scott, 66, passed away Oct. 1, surrounded by loved ones near his home in Prairie Village, Kansas.

He was a longtime specialist with Chartrand Communications, the Society's association management firm. He was a familiar, and busy, fixture for nearly 20 years at the annual IRES Career Development Seminar, working at the registration desk, taking photos, helping speakers with audio-visual equipment — and more.

Scott was a regular contributor to *The Regulator* and designed the Society's first Web site.

Scott Hoober was born March 24, 1943 in Washington D.C., to Daniel and Nora Hoober. He attended the University of Illinois and graduated with a degree in photojournalism in 1965.

From there, Scott took his first job at the Beloit Daily News, in Beloit, Wisconsin, where he met his wife-to-be, Penny. They were married on August 27, 1968, bonded by a love of news and politics, even honeymooning in Chicago during the riots of the Democratic National Convention.

Scott contributed his considerable writing talents to several papers in the Midwest before settling in Kansas and shifting his focus to Media and Public Relations, most notably as Media Liaison for the KCMO Police Department.

He went on to work for the Federal Reserve Bank of Kansas City, and then opened his own company, Hoober and Associates. In addition to his love of writing, Scott held a lifelong passion for photography.

Scott was a champion of the environment long before it was in vogue, volunteering for the Kanza Chapter of Sierra Club, and hiking throughout remote areas of the US and Canada. He was also a Boy Scout Troop Leader. Scott believed in public service and was a patron of the arts, giving his time to the Heart of America Shakespeare Festival, the Fringe Festival, and the local Blues and Jazz Club. Scott was also a member of IRES and the International Association of Business Communicators. He cherished the friendships he made through these organizations.

His friends will remember his quick wit and vast knowledge of current events as well as history. Whether it was hiking a challenging trail, dealing with an intellectual dilemma, or facing a terminal diagnosis, Scott faced it all with grit and determination rarely seen in men half his age.

A lifelong non-smoker, Scott refused to let metastatic lung cancer get him down, and continued to make the best of life throughout his 18-month fight. He defied all odds in his survival, due to his optimism and the caring and determination of Dr. Karen Kelly and Kizzy Allen, RN, of the KU Cancer Center.

It was Scott's final wish to have his body donated to the Kansas University Medical School, in hopes that he could help others.

Scott is survived by his wife, Penny Hoober, children, Steven Hoober (and his wife Alison); Christine (and her husband Bryan Sowell); grandchildren, Tyler, Henry, and Addie; sister, Geri Maskell; and aunt, Charlotte Stone.

The family requests that donations be made in Scott's name to Kansas City Hospice and Palliative Care. Scott's family is forever grateful for the care and respect given to Scott in his final days at Hospice House. Donations can be mailed to Kansas City Hospice and Palliative Care, 9221 Ward Parkway, Suite 100, Kansas City, MO 64114. They also can be made online through **www.kansascityhospice.org.**

*Casual Observations*

# Watch out for the "Smart Guys"

Last month, while mulling over the lessons from the current economic crisis, we came across a *New York Times* op-ed piece by author Calvin Trillin. In the article, Trillin claims he met a "well-preserved, gray haired man" in a Manhattan bar who offered to explain — in one sentence — why the economy had collapsed. After taking a leisurely sip of his martini, the man said:

*Smart guys started working on Wall Street.*

Back in the day, explained the gentleman, the top third of his college class went on to become judges, academics, and scientists (he was probably an Ivy Leaguer). It was the bottom third that majored in business and ended up on Wall Street.

While those bottom-thirders ended up earning far more than their sharper classmates, they weren't particularly greedy. They were quite comfortable with the one home in Connecticut and perhaps a sailboat.

So what brought the smart guys in? Two things: the dazzling amounts of money that could be made on Wall Street and the increase in college debt. Soon whiz kids from MIT and Caltech were abandoning their plans for graduate school in physics and heading to Wall Street "to calculate arbitrage odds." Wall Street was no longer staid and boring.

And those who ran the Wall Street firms were still those old guys from the bottom of the class who didn't have a clue what a credit default swap was. "All [they] knew," claimed the elderly sage, "was that they were getting disgustingly rich, and they had gotten to like that. All of that easy money had eaten away at their sense of enoughness."

Trillin concluded his piece by saying the theory sounded too simple, but "offhand I couldn't find any flaws in it."

So what is the lesson for insurance regulators? Simple — Keep those "smart guys" out of insurance. Warren Buffett was right: *Beware of geeks bearing formulas.*

— *W.C.*

# Are You **LinkedIn**?

Have you ever wanted to do more networking with fellow IRES members but not sure where to start? Well, it's easy to do if you are LinkedIn. IRES members that are LinkedIn can now join the IRES group on **LinkedIn**. Simply search for the Insurance Regulatory Examiners Society or IRES group. The group is open to all IRES members. LinkedIn is a social networking website designed to help build your professional network. Visit LinkedIn **(www.linkedin.com)** for more information.

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The Regulator

What are the lessons for insurance regulators from the economic crisis?

INSIDE: Lessons for insurance regulators from the economic crisis. *Special Edition.*

# BULLETIN BOARD

√ **Bulletin Board CORRECTION:** Throughout the commissioners' interview that appeared in the September 2009 issue ("Preserving a State Voice in Health Care Reform"), Maryland Deputy Insurance Commissioner Beth Sammis was misidentified as Beth Sannis. She was also misidentified in a photograph that appeared on page 13. Our apologies to Deputy Sammis for the error.

√ **ASSISTANCE PLEASE:** Would you like to see a specific topic covered at next year's Career Development Seminar? The Education Committee seeks your assistance in ensuring that CDS sessions meet your needs and desires. Send ideas to Wanda LaPrath at WMLaPrath@aol.com.

**In the next REGULATOR:**

- *Identity Theft Insurance*
- *Federal Insurance Office Act*

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.

***See you next year.***
***Have a happy holiday!***