

The Regulator[®]

INSURANCE REGULATORY EXAMINERS SOCIETY

Regulating Health Insurance Rates

Ario: Feds Can Set Standards but States Must Enforce

by *Steve Tuckey*

Special to The Regulator

The federal government could play a useful role in the regulation of health insurance rates, just as long as it does not take over the whole show, said one veteran commissioner.

Pennsylvania Insurance Commissioner Joel Ario told *The Regulator* shortly after the Health Care Summit on Feb. 27 that “there should be a partnership between the state and federal governments in that the federal government could set strong rate review standards as long as the states have the final authority to implement and enforce them.”

Last month President Obama proposed setting up a Health Insurance Rate Authority in an attempt to restart stalled health care negotiations.

The move came in response to outrage sparked by a proposed 39% rate increase proposed by Anthem Blue Cross in California.



Joel Ario

The new federal authority would go beyond what was contained in either the House or Senate bill on the issue. States currently have varying degrees of authority over the regulation of health insurance rates with more than half allowing increases to go into effect without any prior approval, even those as large as Anthem’s. California falls into that category.

Ario said he would welcome additional authority provided under the guise of a federal mechanism to regulate rates in Pennsylvania. But he warned that states have to have the final authority so that all stakeholders in the process know where the buck finally stops.

Jane Cline, West Virginia Insurance Commissioner and president of the National Association of Insurance Commissioners, agreed that a federal-state partnership in which the states have the final say remains the best solution for keeping insurance premiums affordable.

“We understand that the final language will simply establish a federal backstop to assist those regulators who do not have full rate review authority under state law and ensure that the proposed rate increases are truly justified and receive a thorough review before they become effective,” she said.

continued on page 13

Permitted Practices Pose Problems for Insurance Consumers

by *J. Robert Hunter*

The major investment banks Bear Stearns and Lehman Brothers failed because of weak capital standards. When insurance giant AIG failed, the NAIC and individual state insurance regulators were quick to point out that, because of stronger capital and reserve requirements, AIG’s insurance units were financially sound.

Yet, state insurance regulators have been, over the past year, loosening some of the very standards that have helped keep insurance companies sound.

Some think that the life insurance industry narrowly missed a major meltdown a year ago and is not yet entirely out of the woods as potential mortgage issues remain to be dealt with. For example, Fitch Ratings, a global credit rating agency, now predicts \$15 billion in future real estate losses for the industry. In the face of such potential danger, American consumers need

continued on page 6



MARCH 2010

President’s Column	2
Defective Drywall	4
Annuity Concerns	9
Data Compromise Coverage	12
Regulatory Roundup	16
Casual Observations	18

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From the President

Spring is in the Air

As you read this edition of *The Regulator*, most of you, I'm sure, are eagerly looking forward to spring. It certainly has been quite a winter. Just about every part of our country has felt nature's wrath. As the weather warms, however, many of you will undoubtedly begin to plan for family excursions and summer vacations. For those who have not already done so, I would encourage you to mark your calendars and register for this year's IRES Career Development Seminar (CDS).



IRES has a long history of providing its members with quality professional development options. At the center of IRES' training is the annual CDS. This year the CDS is located in Albuquerque, New Mexico at the Hyatt Regency and scheduled for August 29 – 31, 2010.

I want to acknowledge and thank **Mark Hooker**, this year's Education Committee Chair; **Joe Bieniek**, Vice Chair; and **Wanda LaPrath** and **Stephen Martuscello**, CDS co-chairs for their hard work in developing the session. The theme for this year's CDS is "Expanding the Frontier of Insurance Regulation." Certainly a timely theme, as this nation stands at the crossroads of regulatory change in our financial services markets.

Elsewhere, the Board of Directors has been busy attempting to develop and adopt a Succession Plan. It is imperative that IRES institute a plan to allow a smooth transition from one management team to another in the event of some unforeseen circumstance or by normal business activity. Presently, no such plan exists and our organization stands at risk if such a need should arise any time in the future.

A succession plan would include a general blueprint for responding to unforeseen events

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such as death or retirement of the current Executive Secretary or the dissolution of the current management company and/or the replacement of the current management company as the result of normal business activity. Special thanks to **Tom Ballard** and his Succession Plan committee for all their hard work.

Finally, our longtime editor of *The Regulator*, **Wayne Cotter**, has advised that he will not be returning as editor next year. Having served in that capacity since 1998, he felt it was an appropriate time to pass the torch to someone else.

Wayne, we thank you for all your help to IRES over the years and we wish you well. You will be missed!



Dennis C. Shoop, MCM
IRES President

Welcome, new IRES Members!

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Continuing Ed News

With the current economic climate and tight department budgets, AIE and CIE designees are reminded that IRES recently made changes to CE requirements to allow for attaining CE credits in several low-cost ways.

IRES members can earn up to three CE credits annually for active participation in IRES committees and/or subcommittees.

If a member cannot participate in Committee work, volunteers can earn up to three CE credits for doing special projects or research work for IRES that is approved by the Chair or an IRES Executive Officer.

(Note: the total number of credits awarded per year for committee or subcommittee participation and special projects cannot exceed three credits.)

Online Continuing Education courses that provide for verifiable registration of the user and an internal testing program that can assure that the registrant

successfully passed the course are considered "proctored" and may be submitted for consideration of CE credits. The content must be more than 50% directly and substantively insurance related. Credit is awarded based upon actual contact hours.

The Technology and CE Subcommittee of the Accreditation and Ethics Committee continues to explore other lower-cost methods for members to meet CE requirements. If you have ideas to share, please e-mail A&E Chair, Anne Marie Narcini at annemarie.narcini@dobi.state.nj.us.

Don't forget that attendance at the Career Development Seminar in Albuquerque this August satisfies your annual CE requirements. Hope to see you there!

N · I · C · E
National IRES Continuing Education

Defective Drywall Distresses Consumers, Insurers

by Steve Tuckey

Will purportedly dangerous Chinese drywall turn out to be the next mold-like issue threatening the stability of the homeowners' insurance market?

At this point that seems highly unlikely. But that has not stopped regulators and insurers from being concerned about the property damage and health hazards said to be stemming from drywall manufactured in China and whether the damage can be remediated in a cost-efficient and equitable manner.

Jack McDermott, director of communications for the Florida Office of Insurance Regulation, said that the term "defective drywall" is now being used since not all the material in question comes from China.

As for insurer liability, he said the standard homeowners' contract does not cover the risk of defective building materials, including defective drywall, as insurers do not incorporate that risk into their underwriting and rates.

McDermott said that one potential solution could be to create a fund similar to one for asbestos removal. "Ideally, builders, contractors and suppliers and the federal government could contribute to this fund and affected consumers could make claims against this fund in exchange for waiving their legal claims," he said.

Overall, McDermott termed the issue "very dynamic and involves pending litigation and legislative proposals at the state and federal levels."

Following a hearing at its December annual meeting last year, the National Association of Insurance Commissioners is expected to offer some interim conclusions. But they are not anticipated to be made public before the spring session at the end of this month.

David Golden, senior vice president for the Chicago area-based Property Casualty Insurers Association of America (PCI), termed the entire issue as "developing."

"We still don't know what the actual process is that is causing the sulfurous emissions that have been correlated with the drywall coming out of China," Golden said.

But he did hold out hope that evolving science around the issue could come up with a solution for remediating the problems caused by the drywall short of tearing it all out, while agreeing that would not settle the question of who should pay for it.

As of January 25, the U.S. Consumer Product Safety

Commission reported 2,833 incidents related to drywall from 37 states with more than 90% coming from five states: Florida (59%), Louisiana (21%), Mississippi (6%), Alabama (5%) and Virginia (4%).

The Commission said that it was working closely with the Lawrence Berkeley National Laboratory to analyze draft emissions testing data "that will

likely confirm our hypothesis that there are elevated emission rates for hydrogen sulfide from some Chinese drywall compared to non-Chinese drywall given the type of corrosion that we have seen in the homes we have visited."

As for the question of insurer liability, Florida's Citizens Property Insurance Corp. said that it would continue covering James and Maria Ivory, a retired couple whose Gulf Coast home was built with problem materials that emitted sulfuric fumes that corroded pipes.

Citizens at first not only denied the claim made in October of last year but announced it would not renew the policy because of the defective drywall that could lead to other losses. But according to Citizens spokesman John Kuczanski, further inspection revealed that the damage was not as extensive as previously thought and coverage would be renewed.

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California-based insurance attorney Charles Miller suggested that the regulators may consider joining in a multi-state market conduct exam to ensure proper investigations of Chinese drywall claims and complaints are being conducted.

Covered or Not?

The question then becomes whether the loss that resulted from the defective drywall is covered or not. In the case of the Ivory home, corrosion damage to the heating and plumbing systems was not, but there are perils that could be covered.

But that still raises the issue of homeowners who file Chinese drywall claims and not only see those claims denied, but their coverage nonrenewed as a result. The Associated Press reported two other insurers in Florida cancelled policies after Chinese drywall claims.

Late last year, Louisiana Insurance Commissioner James Donelon said his state's laws protect policyholders who have been covered for more than three years from any cancellation or premium-hike threat as a result of reporting Chinese drywall problems.

Golden said homeowner policies are not warranty products and therefore would not cover any replacement of defective drywall. But any final determination of a claim would of course depend on the results of that particular claim investigation, he added.

The current problem stems for the most part from drywall imported from China between 2005 and 2007 when the combination of a housing boom and the back-to-back 2004-2005 catastrophe seasons created a shortage of materials.

At the December NAIC hearing, speakers agreed the issue was complicated and evolving as attempts are being made to determine both the cause of the drywall defects, and the nature of the illnesses they are said to cause.

The NAIC's Regulatory Division Director Eric Nordman said there was a bill introduced in Congress that would prevent insurers from cancelling or not renewing homeowners' policies due to the presence of certain types of drywall in the home. In addition, the bill would authorize the homeowner to bring a private

cause of action against the insurer if the homeowner's policy was cancelled.

Nordman described what he termed "heartbreaking" stories about people forced out of their homes because of health conditions. "In many cases people abandoned their homes and have gone to stay in other places," he said.

Also at the hearing, PCI representative David Kodama said despite the fact that Citizens rescinded its nonrenewal action, "our entire industry's public reputation suffered in the resulting media news

coverage." But private insurers will nonetheless continue to operate under the terms of their policy contracts and state-regulated insurance practices, he added.

California-based insurance attorney Charles Miller suggested that the regulators may consider joining in a multi-state market conduct exam to ensure proper

investigations of Chinese drywall claims and complaints are being conducted. Examiners could include insurance consumer representatives. "This in my view would tend to add greater assurance to the general public that their interests are being covered in the examination process," he said.

In addition, he suggested that regulators develop model guidance for the insurance industry so carriers can understand how commissioners expect the applicable insurance provisions to be interpreted and applied. ■

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Louisiana Insurance Commissioner James Donelon said his state's laws protect policyholders who have been covered for more than three years from any cancellation or premium-hike threat as a result of reporting Chinese drywall problems.

Steve Tuckey has written on insurance issues for more than ten years for national publications, including *Risk and Insurance*, *National Underwriter* and *Business Insurance*.

Permitted practices; permitted problems

continued from page 1

conservative capital requirements and investment restrictions to assure the safety of their life insurance products.

But in 2009, insurance companies strongly pressured their home state commissioners to amend accounting rules for life insurers and to lessen consumer protections. Permitted practices, which are nonstandard accounting procedures that permit an insurer to request permission to alter normal accounting rules, were granted in large numbers last year, weakening consumer protection at the very worst time. There was an explosion of permitted practices allowed in 2008 and 2009. In 2008, the most recent year for which such data are available, permitted practices allowed 57 life insurers to increase their capital and surplus by \$6 billion – a 4.8 percent increase.¹

NAIC Hearing

Even if consumer protections later turn out to be sufficient (by luck or otherwise), the damage done to consumer faith in the insurance regulatory system is profound. Consider this: A year ago, after intensive lobbying by the American Council of Life Insurers (ACLI), the NAIC was about to vote through improperly vetted accounting changes (including changes to the use of Deferred Tax Assets in determining surplus) with no due process. Consumer groups intervened, forced out a copy of the proposal and pushed hard to get a hearing.

After the hearing, the NAIC agreed with New York Superintendent Eric Dinallo who subsequently wrote to the other NAIC commissioners: “The industry has not made a credible case for why we need to make changes on an emergency basis and why those changes should be limited to the proposals made by industry.” The January 2009 vote to defeat the ACLI proposal was nearly unanimous. The NAIC announced the decision in a January 29, 2009, Press Release, which read (in part) as follows:

“ While the Working Group’s proposals have merit, we believe such adjustments would be better implemented through the NAIC’s standard protocol, ’ said NAIC Vice President and Iowa

Insurance Commissioner Susan Voss. ‘Any future consideration of changes to regulatory requirements will follow the NAIC’s open, transparent and deliberative process.’ ”

States Provide Reserve Relief

But within days, pressure from the individual domestic life insurers was brought to bear on local commissioners to adopt all or parts of the rejected, improperly vetted proposal and permitted practices were granted *retroactive to 2008 accounts*.² Articles began to appear in the media such as one that noted that Hartford got “almost \$1 billion in reserve relief from a state regulator who is a former executive at the company” after rebuffing consumer group requests that he recuse himself.³

Even Commissioner Voss, who had said that the NAIC process should be followed, abandoned that position within days and jumped on the permitted practices bandwagon. On February 3, 2009, a mere five days after she seemed to have endorsed the NAIC process, Iowa issued Bulletin 09-01 allowing for such changes, retroactive to the previous year’s accounting period.

The Bulletin allows insurers to increase the amount of assets they show in their accounts from Deferred Tax Assets (DTAs) by increasing the time that they can project these assets from one to three years and by raising the cap on the amount possible to claim from 10% to 15% of statutory capital and surplus (C&S). On March 6, 2009, Iowa announced that 11 insurers had used permitted practices, increasing their total C&S by \$841.3 million, a 4.8 percent increase in C&S.⁴

It should be noted that in December 2009, following a contentious debate, the NAIC did approve statutory accounting changes that allowed U.S. insurers to book a higher amount of DTA and boost their statutory surplus for a two-year period.

The following are data from some of the larger permitted practices that domestic insurance commissioners allowed. Clearly, the impact of the permitted practices ranges can be significant:

STATE PERMITTED PRACTICES DATA					
12/31/08 ACCOUNTING PERIOD					
(\$ in millions)					
Company	State	Permitted Practices Impact on Surplus	DTA	Capital & Surplus	Permitted Practices as % of Surplus
Facility Insurance Group	TX	\$449.2	\$0	\$75.8	592.9%
Allstate Life Ins. Co.	IL	1,384.0	140.0	3,248.9	42.6%
Jackson Nat'l Life Ins. Co.	MI	825.6	159.4	3,745.7	22.0%
Fireman's Fund Ins. Co.	CA	507.2	0.0	2,861.6	17.7%
Pacific Life Ins. Co.	NE	529.8	0.0	3,135.8	16.9%
Hartford Life Ins. Co.	CT	655.2	93.6	4,071.4	16.1%
Transamerica Life Ins. Co.	IA	505.0	380.4	4,926.9	10.3%
General Reins. Corp.	DE	887.2	0.0	8,936.8	9.9%
MetLife Ins. Co. of CT	CT	396.2	396.2	5,471.5	7.2%

SOURCE: Insurance Industry Permitted Practice Note 1 Report Summary, 12.31.08 Annual Filing Period; by NAIC staff.

Consumer groups find DTAs particularly inappropriate. The effect is to include a greater amount of non-liquid assets in surplus and to create risky and unreliable projections about DTA. The permitted practices harm consumers by reducing the amount of true liquid resources available to the insurer. By counting more DTA in surplus, less cash is needed to meet regulatory capital standards.

Increasing DTA from 10% to 15% of surplus means that cash-type assets will become a smaller portion of surplus. Extending the projection period from one to three years is particularly ill advised. While an insurer could reasonably estimate DTA a year ahead in a stable environment and market, a reasonable projection cannot be made during an unusual economic period and clearly cannot be made reasonably three years into the future. And it is precisely the purpose of surplus to provide the insurer with a cushion during unexpected times.

Public Policy Concerns

The use of permitted practices in this inappropriate way raises several major public policy concerns beside the obvious one: weaker standards of consumer protection when consumers needed it the most. Here are some of the other concerns:

- The recent experience with permitted practices shatters consumer groups' belief that state regulators would not bow to political pressure on solvency issues. We knew that political pressure on

market conduct, rating and fairness issues worked against consumers but, up until now, we thought solvency was off-limits to such pressure. This is a major, and very adverse, development that undermines the integrity of state regulation.

- Permitted practice actions in the last two years show the danger to consumers of regulatory competition among states. It is a case study in how regulatory arbitrage hurts consumers.
- Permitted practices severely undermine the solvency regulatory framework of the NAIC, making a federal option more likely, since, until now, solvency was state regulation's strong suit.
- Permitted practices give small states incredible power. After New York succeeded in creating a level playing field, Ohio and Iowa disrupted the nation. (This forced New York to require insurers there to file the accounts removing permitted practices in that state, further confusing the regulatory framework.) State regulation thus becomes as weak as its weakest link, further inviting federal regulatory intervention.

The entire permitted practices situation begs the question: Shouldn't any proposal for permitted practices requested of a domiciliary state of a multi-state insurer be subject to a procedure that would

continued on next page

Permitted practices, problems

continued from page 7

protect the consumers in other states? For instance, there could be a requirement for the state of domicile to get approval of all states where the company operates or, at least, states where the insurer had significant market share before acting.

If a state of domicile wants to go forward more quickly for some reason (in last year's experience with the ACLI/NAIC debacle we were often told there is no crisis but we have to rush - an odd combination of thoughts), then the insurer would have to show the accounting both before and after the permitted practices in the annual statement of all states. Some new protections from permitted practices damage must be put in place to protect consumers. American insurance buyers should not have to suffer the effects of undue pressure that insurers can bring to bear on their domestic state commissioners.

ENDNOTES

¹ National Underwriter, "NAIC Posts Permitted Practices Report," 3/10/09.

² Ohio acted prior to the January 2009 vote.

³ Bloomberg.com: "Hartford Got Relief From Ex-Manager Turned Regulator," 2/12/09.

⁴ Calculated using data from the Iowa Insurance Department Web site at: www.iid.state.ia.us/docs/bull0901pp.pdf ■

Robert Hunter is Director of Insurance for Consumer Federation of America. He formerly served as Texas Insurance Commissioner and Administrator of the Federal Insurance Administration.



Permitted vs. Prescribed Practices

Last year, the National Association of Insurance Commissioners compiled a list of insurers that used permitted practices as well as those using so-called "prescribed practices" in their 2008 annual statements.

Permitted practices are those nonstandard accounting practices that have been permitted by state regulators, usually at the request of insurers. "Prescribed practices" are also nonstandard accounting practices, but ones that have been approved by state legislatures for use in their states.

The NAIC listed 57 life insurers using permitted practices in their 2008 statutory filings and 58 using prescribed practices.

As noted in the accompanying article, permitted practices increased life insurers' capital and surplus by about \$6 billion, or 4.8%.

Prescribed practices had an even greater impact, increasing the life insurers' 2008 capital and surplus by \$7.7 billion, or 6.2%.

The NAIC noted that prescribed or permitted practices helped three insurers avoid "risk-based capital events" in 2008.

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Annuities: Protecting consumers with suitability regulation

by Thomas E. Hampton

This article provides background on fixed, variable, and equity-indexed annuities; discusses the circumstances that gave rise to these products; and analyzes the annuity suitability regulations that followed in order to protect consumers.

Background

In the next few years, the “baby boomer generation” will significantly increase the number of U.S. citizens eligible for retirement. Using the years 1946 through 1964 as generational boundaries, boomers will be between 46 and 64 years old in 2010. The biggest concern about retirement, other than finding ways to stay busy, is determining if one has sufficient resources available to maintain one’s lifestyle during retirement years. This process was relatively simple when companies provided pension benefits to employees under defined benefit plans. These plans guaranteed a set monthly amount to retirees for life and, in some cases, provided cost of living increases. In recent years, companies have switched from defined benefit plans to defined contribution plans, which are more of a retirement savings program. Under a defined contribution plan, an employer promises certain contributions to an employee’s retirement account, with no guaranteed retirement benefit.

As the “baby boomer generation” (with the defined contribution plans) nears retirement age, many have looked for strategies to convert the funds accumulated in their 457, 401(k), and 403(b) retirement plans to a monthly payout process similar to the old defined benefit plans. The financial services industry, specifically life insurance companies and national banks, have developed products to address this issue. Insurance products, such as variable and fixed annuities, were the first response to the concerns of retirees.

As the needs for prospective and current retirees changed, the products added benefits to address these new concerns. Companies that offered annuities added death provision riders, which guaranteed a death benefit, and a living provision rider that guaranteed a minimum rate of return on the annuity deposited funds. The selling of these complex and sometimes sophisticated products required consumers to place

a tremendous amount of trust in the broker or representative offering the product.

Establishing Suitability Standards

The Securities and Exchange Commission (SEC) defines “suitability” as a stated or implied requirement that a broker or investment advisor must have a reasonable basis to believe that a certain investment decision will benefit a client before making such a recommendation. The broker or investment adviser must act in good faith and may not knowingly recommend bad investments. For several years, suitability standards existed for broker-dealers and registered securities representatives offering securities products to clients.

The Financial Industry Regulatory Authority (FINRA) is the self-regulatory agency responsible for enforcing suitability requirements on sales of securities products currently through National Association of Securities Dealers (NASD) Rule 2310. (NASD is the predecessor to FINRA.) Variable annuities products were included in the FINRA listing of regulated products and were sold by individuals who were both an insurance producer and a registered securities professional. Each offer had to meet suitability standards, and registered securities representatives had to maintain documentation that they were properly supervised.

The distinction between fixed life and annuity products and variable products is as follows:

- Fixed products provide an agreed upon return with minimal chance of financial loss (similar to a CD).
- Variable products permit one to invest funds in an account where the chance of financial loss increases.

If the fixed annuity category had a minimal chance of financial loss and a minimal correlation to securities, what happened to make insurance and securities regulators want to increase the regulatory requirements for fixed annuities? The answer is equity-indexed annuities.

Equity-indexed annuities are different from fixed annuities because of the way interest is credited to

continued on next page

Annuities: Protecting consumers

continued from page 9

an annuity's value. Most fixed annuities only credit interest calculated at a rate set in the contract. Equity-indexed annuities credit interest using a formula based on changes in the index to which the annuity is linked. These annuities have hybrid features of both fixed and variable annuities. The biggest issues of concern for regulators are the high fees and surrender charges attached to most of these equity-indexed products. Numerous consumers, mostly people in retirement or close to retirement, who requested refunds of their funds soon discovered the high cost of getting out of these contracts and began to complain to their regulators, both securities and insurance.

State securities regulators through their association, the North American Securities Administration Association (NASAA), felt they were better positioned to protect consumers purchasing annuities and should have jurisdiction over equity-indexed annuities. With the support of state securities regulators, the SEC issued Rule 151A that would carve out indexed annuity products from the definition of annuity contracts under Section 3(a)(8) of the Securities Act of 1933.

This proposed change would require that an indexed annuity be treated as a security and sold by registered securities representatives using the suitability standards of NASD Rule 2310 and the supervision standards of FINRA. A lawsuit was filed by three indexed annuities writers with the United States Court of Appeals District of Columbia Circuit that effectively stayed the implementation of the rule. The federal court ruled that while it supported federal oversight of annuity products over state laws, the SEC failed to properly consider the effect of the rule upon efficiency, competition and capital formation. There has been no determination on whether the SEC will decide to meet the requirements outlined by the court.

Suitability Model Regulation

Currently, the National Association of Insurance Commissioners (NAIC) is completing modifications to the Suitability in Annuity Transactions Model Regulation ("Model"), which includes a supervision system for annuity products and insurance producers. The Model is scheduled for final approval by the NAIC Executive Committee at the NAIC Spring Meeting in

Denver in late March 2010. For more information on the Model, go to www.naic.org/committees_a.htm.

The latest 12/21/2009 version of the Model proposes the following major amendments:

- A definition for replacement and suitability information. Suitability information includes age, annual income, financial information, liquidity needs, risk tolerance, and other factors.
- Although the insurance producer will be required to determine the suitability of the recommended insurance product in most situations, this rulemaking places the ultimate burden of determining compliance with the regulation on the insurance company.
- The insurance company is required to establish a supervision system for determining the compliance of its producers with the regulation. This is similar to the supervision standards in the FINRA rule.
- An insurance producer shall not dissuade a consumer from truthfully responding to an insurer's request, filing a complaint, or cooperating with an investigation of a complaint.
- Prior to soliciting the sale of an annuity, the insurance producer is required to complete a minimum amount of annuity product training. The training is divided into two sections: (1) a one-time training course on annuities, and (2) a continuing education requirement for product-specific training. The insurance company is responsible for verifying an insurance producer's compliance with these training provisions.

The inclusion of an effective suitability standard within the insurance regulatory scheme provides effective protection to consumers since insurance regulators have authority over the financial solvency of the company underwriting the product as well as the activities of the producer who is marketing the product.

Enforcement of Suitability Standards

Although the insurance regulatory scheme has the most safeguards to protect consumers who purchase indexed annuities, there are some challenges to administering suitability standards consistently

across the nation. The market conduct regulatory process is not uniformly applied, and suitability rules promulgated in several states are varied. Consistency in the development of suitability standards between jurisdictions on the insurance regulatory side and with FINRA for securities is vital to effective enforcement. The new Model does include a safe harbor provision for producers that have complied with FINRA suitability standards for variable and fixed products, which reduces the duplication of records for producers and, hopefully, the cost to consumers.

Finally, for any enforcement process to work effectively, regulators have to understand the marketing process for indexed annuities. Financial services regulators focus their authority on the entities they license, but in the indexed annuities world, insurance companies contract with Independent Marketing Organizations (IMOs) that are, in most cases, outside of the regulatory umbrella. Regulators should strive to make these organizations more accountable to ensure suitability requirements are fully addressed.

Conclusion

With all of the complex financial products in the marketplace and the need to construct a monthly stream of income during retirement, insurance producers, broker-dealers, and registered securities professionals must understand their clients' financial situations, risk tolerance levels, and financial goals when recommending particular products. Thus, suitability rules have to be comprehensive, enforceable, and consistent across regulatory schemes in order to benefit the consumer and not place an undue burden on the representative and, ultimately, the consumer. ■



Thomas E. Hampton is Senior Advisor with Sonnenschein Nath & Rosenthal LLP. He previously served as Commissioner of the D.C. Department of Insurance, Securities and Banking from 2005 to 2009 and as Deputy Commissioner from 2000 to 2005. He can be reached at thampton@sonnenschein.com.

2010 CDS

Beauty Abounds, Both Above and Under Ground, in NM

The IRES CDS is fast approaching (August 29-31). As always, the sessions offer great educational opportunities for regulators. Other educational opportunities also await IRES visitors to New Mexico — before or after the CDS.

For example, the Carlsbad Caverns National Park is just a five-mile drive south of Albuquerque. Other sites to visit along the way:

- White Sands National Monument, which is four hours south of Albuquerque;
- Roswell, with its International UFO Museum and Research Center;
- Mescalero Apache Reservation, with its Inn of the Mountain Gods Resort, including a nationally ranked golf course and a casino;
- Socorro, with the Bosque del Apache National Wildlife Refuge and a large array of radio telescopes;
- Truth or Consequences, with Elephant Butte Lake State Park and featuring hot springs and several bed and breakfast inns;
- Alamogordo, with the Museum of Space History and the Lincoln National Forest; and
- Silver City, with the Silver City Museum, Gila Wilderness, Gila Cliff Dwellings National Monument, and Whitewater Canyon.

There is a lot to see and do in New Mexico and the surrounding areas. More possibilities for educational and fun trips will be presented in future issues of *The Regulator*. For additional information, check out the links on the IRES Web site.

Data Compromise Coverage Helps Businesses, Victims

by Keith Langan, JD, CPCU

Any business that stores personal information — such as Social Security numbers, credit card information or health information — can be the victim of a data breach. Networks can be hacked, a laptop computer stolen or personal information inadvertently revealed in an e-mail or on a Web site. Personal information can be compromised — lost, stolen or divulged — impacting the company and ultimately affecting its reputation and bottom line.

Many state laws require businesses to notify individuals whose information has been compromised, and it may only be a matter of time before a similar federal law is enacted. In order to help their commercial policyholders remain compliant and help maintain goodwill with their valuable customer base, insurers have developed products like data compromise coverage that provide assistance throughout the data recovery process.

For example, under coverage provided by Fireman's Fund, the insurer will work with businesses to determine the next steps in the event of a data breach; pay for notification to those affected by the breach, including the establishment of a toll-free hotline; and provide data theft victims with access to one of the world's leading security and identity recovery specialists.

Data compromise coverage helps businesses respond quickly and effectively to a data breach. It covers the costs to notify affected individuals and provides a suite of services, from credit report monitoring to identity theft restoration case management.

Companies that are not able to provide high-quality services for affected individuals are at increased risk of alienating their customers and hurting their public image. Data compromise coverage is designed to provide businesses with a practical solution to a very real problem.

Breach of Card Security

Another serious data breach issue that retailers face is the breach of their payment card security systems.

While most retailers, merchants and service providers (including restaurants) are aware of the risks of credit and debit card fraud, they may not realize the cost and extent of the penalties and other expenses they face from a breach in their payment systems.

Main street businesses are particularly vulnerable because they often do not have the resources to properly manage their risk.

Large or small, any business that falls out of compliance with Payment Card Industry (PCI) Data Security Standards can face steep contract penalties or negative publicity. The cost of compliance can include the extra expenses to upgrade and certify that their software systems are up to date with the latest PCI standards. A merchant could find itself out of compliance with applicable data security standards for a number of reasons, including:

- Improperly storing cardholder data on point-of-sale systems
- Systems connected to the Internet or wireless networks;
- Using system default passwords instead of customized passwords; and
- Exposing unsecured networks to the Internet.

It is important for merchants to be aware of and be prepared to absorb the additional expenses associated with a payment card data breach. A substantial contractual penalty or expensive payment system upgrade could be financially devastating for a small business.

Fireman's Fund, for example, offers Payment Card Security Extra Expense coverage, which features reimbursement for contractual penalties; upgrades to software and hardware systems; reimbursement for expenses related to the data breach; and payment for crisis expenses to restore the firm's reputation.

Business Continuity Planning

Many organizations ignore essential planning and security measures that would help to ensure the long-term survival of their business. It is important to

identify vulnerabilities, create a plan to address them and reduce the risks.

In order to ensure continuity of business, proactive security measures must be taken and be a part of daily operations. Routine security testing and regularly scheduled assessments and third-party security audits should be performed.

A business should work with its insurer to create a plan for continuity in the event operations are disrupted. Relevant questions to consider are:

- Does the business have an emergency response plan?
- Does the business have employee and vendor lists?
- Has the business identified sources of business disruptions?

- Does the business have plans to restore critical systems?

The Bottom Line

In today's litigious world, protecting customers, employees and others from identity theft is not just a matter of public relations; it goes directly to the bottom line. Lost or stolen data can generate embarrassing media attention and legal complications. In addition, the costs of notifying affected individuals and helping them restore their identities can be huge. We encourage businesses and regulators to learn more about these important coverages. ■

Keith Langan is Senior Counsel with Fireman's Fund Insurance Company. He can be reached at klangan@ffic.com.



Ario: Feds Can Set Standards but States Must Enforce

continued from page 1

Cline added that the proposed new federal authority would not be used to overturn state determinations. Cline also reiterated her opposition to any bill in which the federal government allows insurance carriers to sell their products in states using regulatory rules of another state.

“This misguided proposal would increase premiums for those who need insurance the most and eliminate important consumer protections,” she said. “It would also fragment the insurance market and expose consumers to increased fraud and abuse.”

The proposal has gained traction in the past few weeks as one measure that both Democrats and Republicans seemed to agree on, although varying interpretations of how it would be implemented and what it would mean to consumers indicate that passage of such a measure would prove challenging.

At the beginning of the year, the Democrats seemed headed toward passage of an overall bill that would bring 30 million new customers into the system in exchange for certain cost control measures and the elimination of pre-existing conditions exclusions.

But that consensus seemed to disintegrate with the unexpected election of Republican Scott Brown to the U.S. Senate from Massachusetts that not only deprived the Democrats of their filibuster-proof supermajority but also suggested a general national reluctance to move ahead with radically changing the health care system in the country.

Ario said that reforming the entire fee-for-service concept to one in which all services are paid for under what he termed a global payment system will be a key cost control measure, along with the introduction of a stronger evidence-based system of authorizing health care procedures.

Such measures cannot work, however, without including millions of new payers in a system that would require new subsidies and the taxes and fees to fund them. ■

Steve Tuckey has written on insurance issues for more than ten years for national publications, including *Risk and Insurance*, *National Underwriter* and *Business Insurance*.



IRES Chapter News

ALABAMA — The Reinsurance Association of America conducted a seminar for the Alabama Department of Insurance on January 26 – 27. — *Cristi Owen, Cristi.Owen@insurance.alabama.gov*

LOUISIANA — Two officers of the Louisiana Medical Mutual Insurance Company, **Thomas L. McCormick** (CFO) and **Joan Winters Burmaster** (Assistant Corporate Secretary and General Counsel), discussed ethics and business conduct at our December 14 Chapter meeting. The session included discussions of corporate values and ethics in matters of governance and oversight; making ethical decisions; ethics in training; importance of a company's code of ethics; and the difference between a code of ethics and a value statement. A copy of the Louisiana Medical Mutual's "Code of Ethics and Business Conduct" was distributed to the 13 attendees.

The Louisiana Chapter held another State Chapter Meeting on January 15. **Lorraine LeBlanc**, Executive Director of The Louisiana Patient's Compensation Fund, delivered a PowerPoint presentation entitled "*The Patient's Compensation Fund: Who We Are, What We Do, and How We Do It.*" Subjects discussed included Louisiana laws; statutes of limitations; history of the PCF and the PCF Oversight Board;

unfunded liabilities; and a comparison of rates in Louisiana and neighboring states. There were 20 attendees at the meeting.

— *Larry Hawkins; lhawkins@ldi.state.la.us*

NEW YORK — On February 12, the New York Insurance Department professional staff participated in a comprehensive and diverse discussion of the state of the property/casualty industry in 2010. **Robert Hartwig**, President of the Insurance Information Institute, discussed a wide range of issues that included insurance industry financial and market trends, current New York no-fault automobile insurance experience and legal trends, and how the financial services industry has changed over the past few decades.

Mr. Hartwig's presentation was sandwiched between thought-provoking discussions on current property/casualty issues led by Chief Actuary **Anne Kelly** and Assistant Property Bureau Chief **Joe Smeragliuolo** and Deputy Property Bureau Chief **Maurice Morgenstern**. Department staff from New York City and Albany attended the seminar. The session provided valuable insight into the issues we face as regulators and assisted active IRES members in meeting their annual continuing education requirements.

— *Maurice Morgenstern; mmorgens@ins.state.ny.us*

Book hotel rooms *now* for CDS

Even if you're not sure you will attend the Albuquerque meeting, it's wise to reserve hotel rooms early. The Hyatt is holding a limited block of rooms at a special rate for IRES guests. When those rooms are sold out the hotel may charge a higher room rate.

the National School on Market Regulation

April 18-20, 2010

Fairmount Chicago, Chicago, IL

Be the first to get the latest regulatory scoop! Gain first-hand knowledge of the direction states are taking on YOUR issues.

The annual school is a MUST for:

- insurance industry and private sector compliance & market conduct
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The agenda is loaded with tools to hone your compliance skill set, including:

- sessions on building your company's market analysis function
- agent licensing and appointment
- L&H annuity sales
- compliance controls and metrics
- social media in the insurance market



FACULTY/SPEAKERS:

Commissioners: Joel Ario (Pennsylvania) ■ Jane Cline (West Virginia) ■ John Huff (Missouri) ■ Michael McRaith (Illinois)

Faculty: Lynette Baker (Ohio) ■ Joe Bieniek (NAIC) ■ Eric Cioppa (Maine) ■ June DuBard (South Carolina) ■ Luther Ellis (District of Columbia) ■ Dudley Ewen (Maryland) ■ Mark Hooker (West Virginia) ■ Rolf Kaumann (New York) ■ Gail Keren (New York) ■ Leslie Krier (Washington) ■ Jo LeDuc (Wisconsin) ■ Craig Leonard (NAIC) ■ Bill McAndrew (Illinois) ■ Rosanne Mead (Iowa) ■ Jim Mealer (Missouri) ■ Jay Morton (Virginia) ■ Tim Mullen (NAIC) ■ Manny Munson-Regala (Minnesota) ■ Anne Marie Narcini (New Jersey) ■ Eric Nordman (NAIC) ■ Barbara Szumowski (Florida) ■ Ignatius Wheeler (Texas)



Register at ires-foundation.org



Regulatory Roundup

New York — Insurance Department issues comprehensive producer disclosure regulation

In an effort to bring greater transparency to compensation paid to insurance producers and their role in insurance transactions, the New York Insurance Department, on February 10, issued a new Regulation 194 (11 NYCRR 30), establishing minimum disclosure requirements producers must make at or prior to the time an application for insurance is completed. The disclosures include: (i) a description of the producer's role in the transaction; (ii) whether the producer will receive compensation from the insurer or other third party based on the sale; (iii) notice that the compensation paid to the producer may vary depending on a number of factors, including the volume of business done with the insurer or its profitability; and (iv) notice that the purchaser may request additional information about the compensation the producer expects to receive from the sale. If the purchaser requests additional information on the producer's compensation, the producer must also provide in writing a description of: (i) the nature, amount and source of compensation to be received by the producer or any parent, subsidiary or affiliate based on the sale; (ii) any alternative quotes presented by the producer; (iii) any material ownership interest the insurance producer or any parent, subsidiary or affiliate has in the insurer or vice versa; and (iv) a statement regarding whether the insurance producer is prohibited by law from altering the amount of compensation received from the insurer. In the event the nature, amount or value of the compensation to be received by the producer is not known at the time the disclosure is required, the producer must include in the disclosure a description of the circumstances that may determine the receipt and amount or value of the compensation, and a

The New York-based Stroock & Stroock & Lavan LLP Insurance Practice Group includes Donald D. Gabay, Martin Minkowitz, William D. Latza, Boris Ziser, Thomas Weinberger, Bernhardt Nadell and Keith Andruschak. The Insurance Practice Group also includes insurance finance consultants Vincent Laurenzano and Charles Henricks. They gratefully acknowledge the assistance of Robert M. Fettman, an associate in the group. This column is intended for informational purposes only and does not constitute legal advice.

by
**Stroock & Stroock &
Lavan LLP**

reasonable estimate of the amount or value, which may be stated as a range of amounts or values. Regulation No. 194 does not apply to reinsurance, placement with a captive insurance company or to an insurance producer that has no direct sales or solicitation contact with the purchaser. The Regulation, which underwent several draft iterations to address industry concerns, takes effect as of January 1, 2011. To view Regulation 194, visit the Insurance Department's Web site at www.ins.state.ny.us.

Delaware — Governor signs bill raising life and health guaranty fund limits

On Jan. 21, Governor John Markell signed into law HB 202, a bill implementing changes to the Delaware Life and Health Insurance Guaranty Association Act (the "Act"), including increasing the statutory coverage limits available to Delaware policyholders in the event of an insurance company insolvency. The Bill increased the maximum amount of coverage the guaranty fund will pay under each long-term care insurance and disability insurance policy from \$100,000 to \$300,000; for fixed annuity contracts from \$100,000 to \$250,000; and to each payee of a structured settlement annuity plan (or the beneficiary of a payee who is deceased) from \$100,000 to \$250,000. According to a February 15 press release from Delaware Insurance Commissioner Karen Stewart, HB 202 will provide immediate benefit to at least 165 Delaware policyholders who potentially face loss of coverage because of pending proceedings seeking an order of liquidation against their insurer. HB 202 also revised various provisions to conform the Act to the NAIC Life and Health Insurance Guaranty Association Model Act. To view HB 202, visit the Delaware General Assembly's Web site at www.legis.delaware.gov.

New Jersey — Legislature approves producer disciplinary action reporting bill

On Jan. 17, A1878 was enacted into law. It mandates

the reporting by producers of administrative enforcement action against licensed insurance producers by certain noninsurance regulatory authorities. Specifically, the bill requires insurance producers licensed in New Jersey to report to the Commissioner of Banking and Insurance (the “Commissioner”) any disciplinary action taken against the producer or the initiation of formal disciplinary proceedings against the producer by the Financial Industry Regulatory Authority (or any similar nongovernmental regulatory authority with statutory authority to create and enforce industry standards of conduct) within 30 days of the final disposition of the matter. The report must include a copy of the disciplinary order or other relevant legal documents. If the producer fails to report any such action, the Commissioner may suspend the producer’s license and impose a fine against the producer (\$10,000 for a first violation, \$25,000 for a second violation, and up to \$100,000 for a third or subsequent violation). To view A1878, visit the New Jersey Legislature’s Web site at www.njleg.state.nj.us.

Illinois — Governor signs health claims review bill

On Jan. 5, Governor Pat Quinn signed into law HB 3923, a bill known as the “Illinois Insurance Fairness

Act” (the “Act”), which becomes effective July 1, 2010. The Act requires all health insurers and HMOs to provide an internal appeals process for denied claims, and to notify affected policyholders of the right to request an independent external review of the denial. To be eligible for external review under the Act: (i) the individual receiving or requesting the treatment must be covered under the plan at the time of treatment; (ii) the treatment in question must be a covered benefit under the plan, but does not meet the insurer’s or HMO’s requirements for medical necessity or effectiveness; and (iii) the individual has exhausted the internal appeals process. The external reviews must be conducted by nationally accredited Independent Review Organizations approved by the Illinois Department of Insurance (the “Department”) every two years. Previously, only HMO enrollees had the right to an independent external review when their claims were denied. The Act also establishes a committee within the Department to create a standardized health insurance application for use by all insurers and HMOs offering coverage in the individual and small group markets (2-50 employees). Health insurers and HMOs must use the standardized application beginning Jan. 1, 2011. View HB 3923 at www.insurance.illinois.gov.

“Quote of the Month”

Since Watergate, we have tried to make government as open as possible. But as William Galston of the Brookings Institution jokes, government should sometimes be shrouded for the same reason that middle-aged people should be clothed. This isn’t Galston’s point, but I’d observe that the more government has become transparent, the less people are inclined to trust it.

— David Brooks, op-ed columnist, *The New York Times* (2/18/10)

A New Kind of Pet Insurance?

Pet insurance, once unheard of, is now an accepted means of protecting oneself from escalating veterinary bills. Now a firm called Eternal Earth-Bound Pets (EEP) is offering a service that provides lifetime care for pets in a post-Rapture world. For \$110, EEP promises its representatives will assume the care of your pets should the Rapture arrive within the next ten years.

For those unfamiliar with the Rapture, it is a belief among certain Christians that true believers will someday be lifted to heaven. Eternal Earth-Bound Pets is not staffed by true believers; in fact all of its representatives are atheists. But the company claims that should the Rapture occur, some very practical questions will arise, such as: *What becomes of the pets of true believers?*

Eternal Earth-Bound Pets says it can help. Being atheists, of course, they do not believe in the Rapture, but say they “respect the beliefs of others” and are “open to the possibility” that such an event could occur.

The service, which the company swears is not a joke, raises a number of questions in our mind. For example:

Why should true believers trust atheists to honor their agreements?

The company says being an atheist doesn't mean one lacks ethics or morals. “All of our representatives,” says EEP, “are normal folks who . . . have friends of varying beliefs.”

How can a company sell a service that it believes will never be honored?

Does a company really have to believe in a service to sell it? Plenty of smart people sold credit default swaps never thinking they would need to make good on them. Of course that didn't work out so well.

Doesn't this violate a key insurance principle that risks should not be exposed to catastrophically large losses?

This is a tough one because if the Rapture were to occur, virtually every EEP contract would be triggered. However, EEP is careful never to call this service “insurance” and notes that the \$110 fee does not cover the costs associated with the care and feeding of the animals. Those costs are absorbed by the atheist representatives, who also happen to be animal lovers.

The company is run by a guy named “Bart” who declined to provide his last name or sales figures to MainStreet.com, which ran a story on EEP. We note from the company's Web site that Bart appears to have a thriving business selling T-shirts, mugs and tote bags. We suspect Bart's surname may very well be “Simpson.”

* * * *

Hard Numbers

Offering pet care coverage in a post-Rapture world was not the only bizarre concept we came across last month. How about a hard-hitting crime novel that focuses on the efforts of a state insurance department examiner to uncover financial fraud? The novel is “Hard Numbers” by Jackson Bass, a trial lawyer specializing in financial fraud.

The fictional examiner, James McKenzie, works for the California Insurance Department, and is in the midst of a nasty financial examination when he is brutally murdered. The rest of the book explores the efforts by attorney (and former California Insurance Department staffer) Leland Denton to unravel the nefarious links between a California insurance company and a prominent Wall Street bank. As Denton's investigation continues, questions arise as to whether examiner McKenzie was a hero or on the take.

If you're intrigued by an action-packed novel focusing on the work of state insurance departments, “Hard Numbers” may be worth examining.

— W.C.

Albuquerque

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SPECIAL DIETS: Only those requesting a special dietary meal in advance will have one available during the CDS.

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PAID Spouse/Guest name _____

If registering after July 29 add \$40

No registration is guaranteed until payment is received by IRES. A \$25 cancellation fee will be assessed if canceling for any reason.

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

Hotel Rooms: You must book your hotel room directly with the Hyatt Regency Hotel. Call group reservations at 888-591-1234 or hotel direct at 505-842-1234. The IRES convention rate is available until July 29, 2010 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.

\$140.00 Regulator hotel rate

\$165.00 Non-Regulator hotel rate

CANCELLATIONS AND REFUNDS

Your registration fee minus a \$25 cancellation fee can be refunded if we receive written notice before July 29, 2010. 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, 2010.



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What's Inside

Ario on the federal role in
health insurance regulation



BULLETIN BOARD

- ✓ **New IRES phone number:** IRES has a new phone number: 913-768-IRES (4737). The old number (913-768-4700) will remain operational as everyone gets used to the change. The fax number remains 913-768-4900. The IRES mailing address and all e-mail addresses remain unchanged.
- ✓ The IRES Foundation's National School on Market Regulation opens April 18 in Chicago. See advertisement, page 15.
- ✓ Looking for a new career? Be sure to check out the job listings on the IRES Web site, www.go-ires.org.
- ✓ Past issues of *The Regulator* as well as a full index to published articles is also available at www.go-ires.org

In the next REGULATOR:

Health Care Update

*The Pros and Cons of
McCarran-Ferguson*

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.