The Regulator®

INSURANCE REGULATORY EXAMINERS SOCIETY

Furloughs? Cutbacks?

Recession Hits Some States Harder than Others

by Steve Tuckey
Special to The Regulator

So how have state insurance departments weathered the current recession that has thrown overall state finances into disarray?

For the most part, funding levels seemed to have held steady over the past couple of years, although it looks like many departments are taking out their blue pencils in anticipation of possible future cuts.

While some departments are funded through self-generated fees and assessments and others through general revenues, the distinction can get blurred if the governor and lawmakers ultimately retain the right to move the funds as they see fit.

So far no state reported any significant reduction in fees or assessments stemming from the downturn.

Donald Boyd, a senior fellow and former director of the State and Local Government Finance Research Group with the Nelson Rockefeller Institute of Government, said the recession has resulted in shortfalls that are likely to be far greater than in previous economic downturns.

"While both state and local government budgets have felt the impact of the downturn, states are hit harder and sooner than local governments," said Boyd, as quoted in the MuniNetGuide. "Typically states have a more volatile revenue structure than local governments because of their dependence on income and sales taxes."

Boyd said that 44 states experienced a decline in tax revenue in the first quarter of 2009. "And revenue collections worsened after that," he said.

Florida

Florida stands among the states hardest hit by the recession and the decline in property values. And its insurance department is feeling the pinch as a result. Brittany Benner, deputy director of the Florida Office of Insurance Regulation (OIR), said OIR's staffing was reduced from 314 full-time employees to 300 this year, which brings the level back to when the Office was created in 2003. "However, since 2003, the Office now regulates an additional 500 insurance entities," she said.

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Time to Repeal McCarran-Ferguson?

by Howard Mills

Of all the proposals circulating in Congress to fix what's wrong with our financial services regulatory system, the partial repeal of the anti-trust exemption for insurance companies under the McCarran-Ferguson Act is one that industry watchers are spending a lot of time pondering these days.

The politically charged issue has been the subject of many bill proposals over the years, with the most recent one directed at health insurers only. Those in favor of this latest repeal bill believe that ending the health insurance industry's special status will result in lower premiums, an increase in market competition and an end to what the bill's sponsors see as "collusion between politicians and insurance monopolies."

Passed by a 406-19 vote in the U.S. House in late February, the repeal proposal now awaits action in the Senate. Meanwhile, those opposed continue to wonder whether a repeal

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From the President

Education, Education, Education

I'd like to share with you two recent events involving IRES members. The first, after 31-plus years of public service in federal and D.C. government service, **Hazel Mosby** recently retired. Hazel, I'm sure, is looking forward to this time with great anticipation. For the rest of us, it is a time to remember the many accomplishments achieved through the dedicated efforts of individuals such as Hazel.

Since joining IRES, Hazel has served in various capacities such as State Chair and a member of several other IRES committees, including Membership and Benefits and Education. For a number of years, she co-chaired the Enforcement and Compliance section for the annual IRES CDS. For the past three years, she was a member of the IRES Board. For more on Hazel, please see page 16.

The second event was the announcement of this year's Paul DeAngelo Memorial Teaching Award. The IRES Foundation annually honors a current or former insurance regulator who has demonstrated a commitment to insurance regulatory education by increasing and improving regulatory knowledge. Each year, the Foundation announces the winner during its annual insurance school. This year's winner is **Lynette Baker** of Ohio. Lynette is an IRES Board member and certainly very active in NAIC activities.

As you can see, there is a common thread that ties these two events together: *Education.* Both these individuals worked hard to assist other members become better educated, better trained and more professional regulators. Ultimately, this is the very core of our organization's existence. On behalf of IRES, I want to formally acknowledge both Hazel and Lynette for their contributions to IRES and wish both continued success.

I would also like to recommend that you consider becoming actively involved in IRES. For those of you currently serving on committees, I thank you. If you are not currently participating, consider doing so.

Also, keep in mind that the annual IRES Career Development Seminar (CDS) is rapidly approaching. The CDS is the cornerstone of IRES training for regulators and offers insight into current issues and events. This year's agenda focuses on issues impacting all of us. Health care reform will certainly be near the top of the list of issues we'll be discussing at this year's CDS, but also look for sessions on dealing with fraud in a struggling economy, and how states are using their market regulation resources to achieve optimal results for consumers.

For details on these and other sessions, check out the 2010 CDS brochure that was sent to each member (and appears on our Web site). Also, the next *Regulator* will feature a closer look at the upcoming CDS and suggestions on how to spend your off-hours in and around the CDS site, Albuquerque.

Mark the date now: August 29 through 31, 2010. I look forward to seeing you in New Mexico!!

Dennis C. Shoop, MCM
IRES President

Welcome, new IRES Members!

Jacqueline Butler, AIE, TX
Tammy Gavin, Unaffiliated
Joseph A. Haverstick, TX
Keturah Ingram-Isaac, Unaffiliated
Stacy R. Middleton, WA
John Stike, MCM, WV
Cynthia A. Wood, Unaffiliated

“Quote of the Month”

I think everybody a few years ago got caught up in the idea that the markets are self-correcting and self-disciplined, and that the people in Wall Street will do a better job protecting the financial system than the regulators would. I do think the S.E.C. got diverted by that philosophy.

— Mary Schapiro, Chairman, Securities and Exchange Commission

The Most Excellent Adventure of Harvey & Mr. Joseph

by Brian Sullivan

There are these two men, you see. And they have some things in common. They share a town, the City of Angels. They share a passion for California auto insurance. And if you can think in a particularly twisted way, they share a passion for each other. Passionate dislike, that is.

George Joseph, known to all but his nemesis as "Mr. Joseph," is chairman of Mercury Insurance and universally hailed as among the nation's smartest insurance minds. He is also strong-willed and perfectly comfortable throwing his weight around with politicians in order to build a competitive marketplace he believes is most beneficial for consumers and his company.

The nemesis, Harvey Rosenfield, is known to almost all as "Harvey." He is the founder of Consumer Watchdog and one of the most effective insurance consumer activists in the nation. He is nothing if not resourceful, having created California's current insurance regulatory environment with mere pennies despite millions of dollars of insurance industry opposition. He is also perfectly content to spend decades of his life standing as guardian of his 1988 ballot initiative on insurance regulation, Proposition 103.

> *"The initiative would allow Mercury to offer potential customers a discount for having maintained their coverage with competitors."*

As you might guess, on most things insurance Mr. Joseph and Harvey do not agree.

It is through the lens of this relationship that we look at the latest in a long series of skirmishes over California insurance regulation. Mercury is spending plenty of money ($3.5 million, say news reports) and impressive amounts of political capital in an effort to pass another initiative, Proposition 17, which will appear on the June 8 ballot.

Its goal is really quite clear: to allow insurance companies to offer new customers discounts for maintaining continuous insurance coverage. These discounts would be similar to, but not the same as, the "persistency" discounts currently enjoyed by customers who maintain coverage over time with their current insurer.

Specifically, the initiative would allow Mercury to offer potential customers a discount for having maintained their coverage with competitors, such as State Farm, Allstate and Farmers. That would allow Mercury to offer those shoppers a better deal than it can now. Current law — that is, the law Harvey wrote and voters embraced — prohibits insurers from basing rates for new customers on whether or not that customer has consistently maintained insurance coverage.

That restriction irks Mr. Joseph, who would like to be able to compete on a more equal footing with bigger competitors, the better to steal their customers. What could be more pro-consumer than that?

Mercury is going it alone in pushing for such "portable persistency." Though other insurers have not weighed in on their reasons for staying on the sidelines, the reasons seem obvious to us. The most significant is this: Those with the most customers stand to lose the most to new competitors. Current law favors the status quo.

Consumer Disaster?

What of the specific changes created by Proposition 17? Would it indeed be a disaster for consumers who enter and leave the insurance marketplace?

Just how much more would insurance cost for consumers who did not maintain coverage?

The answer to that question is central for many people in deciding how to vote on the ballot initiative. Steve Lopez, the widely read columnist for the *Los Angeles Times*, and a Mercury policyholder who has written thoughtfully about this debate, is one of those who wants an answer.

But here is the problem, which we relayed to Lopez in a recent phone call: Anyone who says with certainty how much consumers will pay is either mistaken or kidding themselves. The variables are so great that an accurate answer simply can't be found.

First comes a definition. A discount for "continuous coverage" that an insurer would offer a new customer is not the same as the "persistency" discount an insurer now offers its long-term customers. The persistency discount includes at least two components. The first is the administrative savings an insurer enjoys by keeping a customer on the books for a long time. The second is the lower claims rate experienced by insurers whose customers keep their insurance in force consistently. The opponents of Proposition 17 do not accept that the claims rate is really lower for customers who maintain coverage, but we're willing to accept insurer arguments that the math works.

> *"Such profits may allow insurers to offer continuous coverage discounts without increasing prices for other customers, masking the dislocation the same way the old territory trick worked out."*

Looking to Prop 103

When Proposition 103 was passed in 1988, insurers were told they must reduce the impact of territory on prices, even though territory was extraordinarily predictive of claims. One result seemed inescapable: lower rates in the cities where claims costs are highest, and higher rates in the suburbs where claims costs are lower. Voters weren't fools, as city dwellers voted overwhelmingly for Proposition 103, while suburban and rural residents generally voted against the measure. The larger number of urban voters carried the day.

But the rate change did not come. Aware of the political pain of disruptive rate changes that would result from truly limiting territory's importance, a succession of insurance commissioners — including two separate terms by insurance industry bashing John Garamendi — resisted implementing Proposition 103 as written. Then an opportunity appeared. In 2006, when insurers were flush with near-record profits in California and Garamendi was near the end of his final term, the Commissioner implemented rules forcing insurers to lower urban rates while holding suburban and rural rates constant. Thus, the benefits of rate cuts all consumers deserved were distributed almost exclusively to urban drivers.

Because of the arcane nature of this trick, there was no political uprising outside the cities. It was the classic "free lunch." Just to hedge his bets, Garamendi set the rules to take place after he left office, lest some unexpected problem tarnish his accomplishment.

This is more than an academic example. California auto insurers are making pretty good money these days. Mercury itself enjoyed a national loss ratio of just 54.9% in 2009. Such profits may allow insurers to offer continuous coverage discounts without increasing prices for other customers, masking the dislocation the same way the old territory trick worked out.

Prop 17 — Likely Results

Bottom line, we're confident arguing thus:

- Proposition 17 would lower prices for insurance shoppers who have maintained consistent coverage, as required by law.
- These lower prices will create more choice for these consumers and a more competitive auto insurance marketplace for most consumers.
- Proposition 17 would increase prices for auto insurance shoppers who have not maintained consistent insurance coverage, whether they have failed to follow the law, just bought their first car, or just returned to California car ownership after a few years riding New York subways.
- The actual increases will be measurable, but given the real world practicalities of the competitive insurance market, not as drastic as pure math would suggest. There are many other factors at play for insurance prices, not least of all the reality of current persistency discounts. Just how disruptive these rate increases will be depends entirely on your point of view.

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Excellent Adventure

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- Higher prices for consumers who do not consistently maintain insurance will probably lead, at the margin, to a larger number of uninsured drivers, and more customers may turn to California's subsidized low-cost (and low-coverage) auto insurance policy.

The Moral High Ground

And so, who holds the moral high ground in this battle? Is it Mr. Joseph and Mercury, who want the majority of law-abiding consumers to have more choices at lower prices? Or is it Harvey Rosenfield and Consumer Watchdog, who want to protect people who have a hard time maintaining their insurance coverage from facing even higher prices?

The answer is that neither holds the moral high ground. There is no right or wrong, only the will of the voters. There are many pricing factors that are highly predictive of loss, yet unacceptable to society. Race is just the most obvious one. To that one we apply a moral virtue. "Consistent coverage" is not on the same level.

In California, voters long ago made clear they wanted to reduce the impact of territory below its predictive power. To this one, we see no morality, merely a matter of the perceived fairness of public policy (or perhaps self-interest by a large group of city voters getting an edge on the smaller group of suburban voters).

Voters are willing to allow insurers to charge them based on their driving record, perhaps because they perceive driving is under their control. Likewise, the public may decide that maintaining the legally required insurance coverage is also under most people's personal control, and therefore is a fair underwriting factor. Or voters may think it unwise to do anything to raise the price for inconsistent insurance buyers, as that might exacerbate the uninsured motorist problem.

As long as California allows voters to micromanage the insurance industry by referendum, underwriting policies like these will be made at the ballot box. If the public thinks it is fair that all companies can offer consumers the same "continuous coverage" discount, they will vote for the change. If they don't like the idea, they can vote against it. Neither decision is "wrong" or "right," and having chosen one course over the other, the insurance-buying voters will be the ones to see the benefits and bear the costs. ■

Brian Sullivan is the California-based editor of Property Insurance Report (PIR) and Auto Insurance Report (AIR). This article is drawn from a piece in the March 22, 2010 issue of AIR. Sample copies and subscription information are available through www.riskinformation.com.

Risk Control: The Responsibility for Failure

by Warren Buffett

A board of directors of a huge financial institution is *derelict* if it does not insist that its CEO bear full responsibility for risk control. If he's incapable of handling the job he should seek other employment. If he fails — with the government thereupon required to step in with funds or guarantees — the financial consequences for him and his board should be severe.

It has not been shareholders who have botched the operations of some of our country's largest financial institutions. Yet they have borne the burden, with 90% or more of the value of their holdings wiped out in most cases of failure. Collectively, they have lost more than $500 billion in just the four largest financial fiascos of the last two years. To say these *owners* have been "bailed-out" is to make a mockery of the term.

The CEOs and directors of the failed companies, however, have largely gone unscathed. Their fortunes may have been diminished by the disasters they oversaw, but they still live in grand style. It is the behavior of these CEOs and directors that needs to be changed: If their institutions and the country are harmed by their recklessness, they should pay a heavy price — one not reimbursable by the companies they've damaged nor by insurance. CEOs and, in many cases, directors have long benefitted from oversized financial carrots; some *meaningful* sticks now need to be part of their employment picture as well. ■

Tuckey: Recession Hits Some States Harder than Others

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In addition to job eliminations, the OIR has ordered reductions in salaries and benefits, expenses and contract services, for an overall operating budget reduction of more than 8% for the fiscal year.

The worst is yet to come, Benner said. As the current legislative sessions were winding to a close, the House was considering cutting 50 of the OIR's 300 positions. "With no reduction in regulatory responsibility, the Office will fail in our mission," she predicted.

California

Across the continent, California's fiscal problems are no less intractable, but according to Darryl Ng, spokesman for the California Department, no cutbacks are in sight. He said the department is funded through special assessments, and not from general tax revenue, and as a result there is enough money in the till to be actually cutting fees.

"Before the current recession, Insurance Commissioner Steve Poizner worked to right-size the department in reducing the 1,300 plus authorized positions to less than the 1,150 we have now," Ng said. "That coupled with efficiencies he and the department staff have created allowed us to save money, reduce fees and still serve the people of California."

> *"Most state insurance department staffers seemed to have fared no worse, and in some cases better, than their counterparts in other state agencies."*

Texas

Texas Department of Insurance (TDI) spokesman Ben Gonzalez said funding has decreased slightly over the past few years, due to voluntarily returning unused funds and requesting less in appropriations.

And although there have been no staff cutbacks so far, that may not last forever. The TDI has prepared a plan for a 5% budget reduction that would among other things cut five jobs in the fraud-fighting unit and 32 jobs in service operations.

North Dakota

Boyd said that North Dakota has been the one state that has so far managed not to see any drop in employment in this recession and the state's insurance department's budget reflects that distinction. Spokeswoman Andrea Fonkert said that funding has increased $2 million in the current two-year period for a total of $16.06 million.

Louisiana

The Louisiana Insurance Department is 98% funded through self-generated fees and assessments. And while there has been no reduction in such revenues in the past two years, the Legislature has shifted some for other purposes. As a result, the department suffered a $2.2 million budget reduction this year and the loss of 22 positions. "Due to internal streamlining efforts and technology, the LDOI has absorbed these reductions," said Deputy Commissioner Shirley Bowler.

Wisconsin

Wisconsin Insurance Department spokesman Jim Guidry said the department has not made any staff reductions but all employees are subject to the mandatory eight furlough days imposed throughout state government.

Oregon

The same thing is true for Oregon where the insurance department is funded through fees and special assessments, and where no special cutbacks have been ordered. But the department must shut down for ten days during the current two-year budget cycle.

Colorado

Colorado also funds its insurance division through special fees and assessments, which have not gone down over the past couple of years, according to Deputy Commissioner John Postolowski, and so no staff cutbacks have been ordered. But like all state employees, division workers must take eight unpaid holidays this year.

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Recession: Some States Hit Hard

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Pennsylvania

Pennsylvania Deputy Insurance Commissioner Ron Gallagher said flat budgets over the past several years have resulted in the reduction of 65 positions through attrition, but no layoffs. "We are not a special funded agency and therefore have not had to suffer the kind of reductions some of those agencies have," he said.

But technological improvements in areas such as producer licensing have resulted in a 50% reduction in staffing levels, with no real loss of service, he said. The same thing is true in the market conduct arena where the number of full-blown examinations has been reduced by almost half through more efficient means of pinpointing and then dealing with troubled companies.

Conclusion

Most state insurance department staffers seemed to have fared no worse, and in some cases better, than their counterparts in other state agencies. During the midst of this economic crisis, it is crucial that insurance departments meet their statutorily mandated obligations. Moreover, departments must have sufficient staff to ensure that their licensees are financially viable and that their states' policyholders receive fair and equitable treatment from insurance companies. State insurance departments appear, at least thus far, to be meeting these objectives.

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

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would actually reduce competition and ultimately prove harmful to the industry and consumers. To answer the question appropriately, a short history lesson is in order.

When Congress passed the McCarran-Ferguson Act back in 1945, one of the aims of enacting the limited anti-trust exemption was to increase competition among all sectors of the insurance industry. The Act also served to grant states the power of regulating the "business of insurance." In the legislation, Congress declared: "No Act of Congress shall be construed to invalidate, impair or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business."

Since that time, many versions of McCarran-Ferguson repeal bills have been unsuccessfully floated in Congress. While repeal language was removed from the recently passed health care legislation, the Health Insurance Industry Fair Compensation Act remains alive and is awaiting action by the Senate.

The bill was whittled down to remove one of the most controversial aspects — repeal of the anti-trust provision for medical malpractice insurance, a property/casualty product. Prior to the provision's removal, the American Academy of Actuaries (AAA) stated that any repeal of the anti-trust exemption relative to medical professional liability insurance would likely reduce the number of insurers that offer such coverage, thus putting upward pressure on professional liability premiums — cost increases that would very likely be passed along to policyholders.

CBO Weighs In

Still, advocates of a repeal assert that more choice and cost savings will result by delegating insurance regulation and enforcement to the federal government. As reported by A.M. Best, House Democrats have pointed to rising premiums across the U.S. as an impetus behind the repeal. However, some believe those claims are not supported by independent industry and public studies, including a recent report by the Congressional Budget Office (CBO).

According to its October 2009 report, the CBO found repealing the anti-trust exemption "would have no significant effects on either the federal budget or the premiums that private insurers charged for health insurance."

Meanwhile, state government groups, whose job it is to balance industry and consumer interests, worry that a repeal would not lower costs for consumers but could have the opposite effect by driving smaller insurers out of the market.

"The limited exemption fosters competition by granting insurers the ability to share loss history and other information, and it ensures that smaller and more regional insurers can compete with large insurers that are less dependent on industry-wide data," the National Conference of Insurance Legislators wrote in a letter earlier this year to Senate Majority Leader Harry Reid (D-NV) and House Speaker Pelosi (D-CA).

Others share this concern. The Insurance Information Institute notes: "The net effect of the limited exemption under McCarran-Ferguson is actually to increase competition by giving smaller insurers, who otherwise would have too little data to develop actuarially credible rates, the tools to compete with larger insurers who have much more data on which to base rates."

> *"State government groups . . . worry that a repeal would not lower costs for consumers but could have the opposite effect by driving smaller insurers out of the market."*

A Limited Exemption

And while catch phrases such as "price-fixing," "highly concentrated market" and "collusion" serve to make consumers nervous — just as "cost savings" and "more choice" serves to calm — insurers that oppose the repeal cite the fact that the current limited anti-trust exemption for the insurance industry is just that: *limited*.

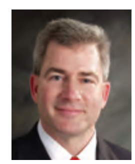
In reality, the exemption allows for joint development of policy forms and leads to better and fairer pricing since it allows insurers to pool historic loss information, resulting in actuarially based pricing for products. Far from allowing insurers free rein, the Act does *not* exempt insurers from state anti-trust laws that explicitly prohibit insurers from conspiring to fix prices or otherwise restrict competition.

Some in Washington believe the time has come to repeal the limited anti-trust exemption under McCarran-Ferguson. They blame it for rising premiums and the consolidation of carriers over the years. They also say that repeal would benefit consumers by increasing competition and lowering premiums. However, there is no credible evidence to suggest that such outcomes would result. The CBO report concluded that with or without a repeal, premiums might increase or decrease, "but in either case the magnitude of the effects [of repeal] is likely to be quite small."

Would repealing the anti-trust provision in McCarran-Ferguson actually yield the opposite effect? Would competition decrease? Would smaller insurers that rely upon the pooled data to set rates be forced out of the market? Would large insurers that can gather their own data dramatically increase their market share? Some say yes.

In addition to non-partisan, independent groups such as the AAA and the CBO, many in the insurance industry believe that a repeal would mean less choice for consumers and a less competitive insurance marketplace. With that in mind, those in favor of the repeal should proceed with extreme caution and remember the old adage: *Be careful what you ask for*. Given what's at stake for the public and the industry, due diligence should trump the quick fix.

Howard Mills is a chief advisor and director at Deloitte's Insurance Industry Group. He is a former New York State Insurance Superintendent.



Federal Mental Health Parity Bill, COBRA, and HITECH

by Melissa Hull

With all of the attention related to The Patient Protection and Affordable Care Act and The Health Care and Education Reconciliation Act of 2010, some recent changes have occurred affecting other health care-related legislation that should not be overlooked. Below is a brief summary of these recent changes and how they may affect the roles we play in the insurance regulatory arena.

Federal Mental Health Parity Bill

On January 1, 2010, the Mental Health Parity and Addiction Act of 2008 ("Act") took effect. The law is designed to create a more level playing field by offering mental health benefits and substance abuse benefits at the same level as medical and surgical covered benefits. The Act covers a variety of group health plans. "Same level" includes deductibles, copayments, out-of-pocket expenses, inpatient stays, and outpatient visits. The Act applies to those employers with more than 50 employees who offer a health insurance plan.

> *"The Mental Health Parity and Addiction Act . . . is designed to create a more level playing field by offering mental health benefits and substance abuse benefits at the same level as medical and surgical covered benefits."*

The Act also ends limits on coverage such as the number of hospital days or the number of visits to a mental health or substance abuse professional, provided the plan does not have a similar limit for medical and surgical covered benefits. Out-of-network coverage will have to be offered for mental health care and substance abuse care – but only again if it is provided for physical illnesses.

Most of the Act's requirements are imposed on employers, including examining their current benefit plans. Employers can also choose which mental disorders to cover, unless state jurisdictions impose additional requirements. As such, the Act does not completely override state jurisdiction. For instance, fully insured plans governed by state law are still required to comply with state law in addition to the Act's requirements. The Employee Retirement Income Security Act (ERISA) preemptions still apply where ERISA currently preempts state law parity. States are still free to enact laws that impose additional coverage beyond the Act. Therefore, questions related to preemption and coverage must be addressed on a state-by-state basis.

In February, the U.S. Department of Labor, Health & Human Services and the Treasury released draft regulations to further carry out the Act, which are slated to take effect in July of 2010. A copy may be found at: **http://www.dol.gov/federalregister/PdfDisplay.aspx?DocId=23511**

COBRA

As the economy turned sour, many employees lost their jobs and the Consolidated Omnibus Budget Reconciliation Act (COBRA) received some serious attention. Originally enacted in 1985, it was extended as part of The American Recovery and Reinvestment Act of 2009 (ARRA). Generally, COBRA provides workers and their families who lose health benefits the right to continue receiving coverage provided by their group health plan for a limited time and often with a steep premium payment. Prior to ARRA, qualified individuals could be responsible for paying premiums for coverage up to 102% of the cost of coverage.

Post-ARRA, eligible individuals now pay only 35%, with the remaining percentage reimbursed to the coverage provider through a tax credit. The involuntary termination, or other qualifying event, must generally occur during the period that began September 1, 2008, and ended on March 31, 2010. The premium reduction applies to periods of health coverage that began on or after February 17, 2009 and lasts for up to 15 months.

> *"In essence, HITECH now requires policies and procedures to be implemented to prevent and address a protected health insurance breach."*

HITECH

Over the years, *The Regulator* has published numerous articles on the importance of protecting sensitive and personal information, especially medical records. While the original Health Insurance Portability and Accountability Act (HIPAA) protected confidentiality of patient records, there were concerns that HIPAA did not go far enough as it related to breaches and civil penalties should a breach occur. As a result, the Health Information Technology for Economic Health Act (HITECH) was enacted and took effect on February 22, 2010. HITECH was also part of ARRA.

HITECH imposes significant obligations on covered entities (health insurers, health care clearing houses, health care providers) and business associates regarding any incident involving a breach of protected health information (PHI). In essence, HITECH now requires policies and procedures to be implemented to prevent and address a PHI breach. The determination as to whether a breach of unsecured PHI is a complicated process, which requires knowledge of both privacy and security knowledge.

If a breach occurs, a covered entity is required to provide notification to individuals affected by the breach, to the media (if the PHI involves more than 500 residents), and to the U.S. Department of Health and Human Services (HHS). It also requires covered entities to provide employee training and whistleblower training. If a violation is found, HHS has the ability to fine a covered entity up to $1.5 million. HITECH also gave broad enforcement authority to state attorney generals.

As with any new or significant federal changes, the real challenge is determining state versus federal jurisdiction in implementing and enforcing these changes and educating our consumers as to the impact these changes can have on our daily lives.

Melissa L. Hull, Of Counsel, Baker, Donelson, Bearman, Caldwell & Berkowitz, is part of the firm's Insurance Regulatory Group. Ms. Hull previously worked for Nationwide as lead counsel and the Ohio Department of Insurance as Assistant Director, Market Regulation and Licensing. This column is intended for informational purposes only and does not constitute legal advice.

On Valuing Proposed Acquisitions

by Warren Buffett
CEO and Chairman of the Board
Berkshire Hathaway

I have been in dozens of board meetings in which acquisitions have been deliberated, often with the directors being instructed by high-priced investment bankers (are there any other kind?). Invariably, the bankers give the board a detailed assessment of the value of the company being purchased, with emphasis on why it is worth far more than its market price. In more than fifty years of board memberships, however, never have I heard the investment bankers (or management!) discuss the true value of what is being *given*. When a deal involved the issuance of the acquirer's stock, they simply used market value to measure the cost. *They did this even though they would have argued that the acquirer's stock price was woefully inadequate — absolutely no indicator of its real value — had a takeover bid for the acquirer instead been the subject up for discussion*.

"Don't ask the barber whether you need a haircut."

When stock is the currency being contemplated in an acquisition and when directors are hearing from an advisor, it appears to me that there is only one way to get a rational and balanced discussion. Directors should hire a second advisor to make the case *against* the proposed acquisition, with its fee contingent on the deal *not* going through. Absent this drastic remedy, our recommendation in respect to the use of advisors remains: "Don't ask the barber whether you need a haircut."

A Value-Destroying Deal

I can't resist telling you a true story from long ago. We owned stock in a large well-run bank that for decades had been statutorily prevented from acquisitions. Eventually, the law was changed and our bank immediately began looking for possible purchases. Its managers — fine people and able bankers — not unexpectedly began to behave like teenage boys who had just discovered girls.

They soon focused on a much smaller bank, also well-run and having similar financial characteristics in such areas as return on equity, interest margin, loan quality, etc. Our bank sold at a modest price (that's why we had bought into it), hovering near book value and possessing a very low price/earnings ratio. Alongside, though, the small-bank owner was being wooed by other large banks in the state and was holding out for a price close to three times book value. Moreover, he wanted stock, not cash.

Naturally, our fellows caved in and agreed to this value-destroying deal. "We need to show that we are in the hunt. Besides, it's only a small deal," they said, as if only *major* harm to shareholders would have been a legitimate reason for holding back. Charlie's (**Editor's Note:** Berkshire Vice Chairman Charlie Munger) reaction at the time: "Are we supposed to applaud because the dog that fouls our lawn is a Chihuahua rather than a Saint Bernard?"

The seller of the smaller bank — no fool — then delivered one final demand in his negotiations. "After the merger," he in effect said, perhaps using words that were phrased more diplomatically than these, "I'm going to be a large shareholder of your bank, and it will represent a huge portion of my net worth. You have to promise me, therefore, that you'll never again do a deal this dumb."

Yes, the merger went through. The owner of the small bank became richer, we became poorer, and the managers of the big bank — newly bigger — lived happily ever after. ■

Strengthening Florida's Property-Casualty Market

by Steve Tuckey

Florida has enjoyed four hurricane seasons free of the kind of major storms that have wiped out neighborhoods and insurance companies. But the debate rages on as to what measures are needed to ensure the state has a robust and fiscally sound property/casualty market with industry and regulators agreeing on some points and taking issue on others.

Press deadline for this article comes as the Florida legislative session draws to a close. But whatever final solutions are reached, they will more than likely be tinkered with in the years to come, especially if there is a repeat of the 2004-05 double whammy of catastrophe years.

In addition, a report in the *Sarasota Herald-Tribune* in March sparked some spirited debate with its assertion that the state's property/casualty market rests on the pillars of numerous underfunded and untested companies.

> *"The report asserts that one in three privately insured Florida homeowners rely on insurers that exhibit one or more signs of financial risk."*

The report asserts that one in three privately insured Florida homeowners rely on insurers that exhibit one or more signs of financial risk as the giant companies such as State Farm and Allstate have packed their bags for less stormy pastures.

"Over the past year, without having to weather a single hurricane, Florida led the nation with a half-dozen property insurance failures," the report stated.

McCarty Letter

In a letter to the state's media outlets, Commissioner Kevin McCarty of the Florida Office of Insurance Regulation (OIR) said that the exodus from coastal coverage by the nation's largest insurers has not been limited to his state, quoting reports from the commissioners in Mississippi and Connecticut to back him up.

And the debate over rate regulation has now taken center stage.

"Some pro-industry proponents have presented deregulation as a panacea," McCarty wrote. "Giving Floridians premium increases of 30% to 40% would cause public outrage, and is a fundamentally flawed strategy." The commissioner said that current proposed legislation provides no guarantees that insurance companies will keep their money to pay claims. "Insurance companies could easily dividend these newfound profits to their shareholders, and the money would be gone," he said.

McCarty noted that the industry has opposed OIR attempts to change Florida statutes to allow transparency and oversight of financial transactions among companies, their managing general agents and affiliates. "Another important fact is that not one national insurer has made commitments to expand their writings if deregulation is achieved," he said.

***Less* Rate Regulation?**

Sam Miller, executive vice president for the Florida Insurance Council, said while his group would support what he called full rate deregulation in one of the legislative proposals, he realizes that Gov. Charlie Crist's threatened veto of that makes it a nonstarter. Instead, he will support a measure that would provide a more limited flexible rating system as a compromise.

But others believe that Crist's veto threat extends to any rate increase proposal, so to fashion a legislative strategy based on that would not be wise.

continued on next page

Florida's p-c market

continued from previous page

William Stander, Tallahassee-based vice president of the Property Casualty Insurers Association of America, said the industry, in addition to more rate freedom, wants to limit the advertising activities of public adjusters within 30 days of a major storm, as well as deal with the fact that Florida, unlike all other states, does not allow carriers to initially hold back some replacement costs—a prohibition in effect since 2005.

A "Chicken Little" Mentality

McCarty seemed most defensive when it came to the *Herald-Tribune's* contention that lawmakers and regulators have ignored inadequate reserves and encouraged private companies to stretch their limited cash further. "Larger dangers loom," the report said. "Despite rising property values, one in three Florida carriers has decreased the cash set aside for storms."

McCarty said public puzzlement over the fact that property/casualty insurers fail during periods of virtually no catastrophe damage is understandable, but has to be viewed from the perspective of an overall declining economy.

He rejected the idea that somehow insurers need to reserve for the 1-in-100 year event. "We cannot be overcome by a "Chicken Little" mentality," he said. State entities such as Citizens Property Insurance Company and the state's catastrophe fund were designed primarily as post-event funding mechanisms in the event of a great shortfall caused by a catastrophe.

And any Katrina-sized event should be handled by a National Catastrophe Plan, he said. "The Florida property insurance market faces substantial challenges," McCarty said. "Yet the public policy debate is being adversely affected by alarmists who mischaracterize the issues, shock the public, and propose vague and untenable solutions." ■

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

2010 CDS

Experience cultures past and present in New Mexico

Have you registered for the IRES CDS yet? The dates for our annual seminar, August 29-31, are just around the corner so don't miss this tremendous opportunity for some great educational sessions. New Mexico also offers great opportunities to explore cultural differences, both current and past.

Both Albuquerque and Santa Fe are known for the Old Town areas with historical sites, shopping, and great restaurants. Albuquerque just recently celebrated its 300th anniversary and this year Santa Fe is celebrating its 400th. You can take a ride on the Rail Runner from the hotel to Santa Fe to partake in the celebration.

In addition, the Pueblo Indian Cultural Center is located in Albuquerque, just minutes away from the hotel. It includes a museum and features dances performed by Native Americans in the area. You may also take tours to the Acoma and Zuni pueblos and gain insight into their culture, both past and present.

Interested in shopping? Once a year, a special Indian Market comes to the Santa Fe area. This year it will be held on August 20 and 21 and will feature over 400 Native Americans displaying their art work and crafts.

Or perhaps you are more interested in the past cultures of the southwest area. Bandelier National Monument, a fabulous cliff dwelling ruins, is just two hours north of Albuquerque and one hour north of Santa Fe. One of the best places for viewing cliff dwellings is Mesa Verde National Park, about five hours northwest of Albuquerque. The park offers tours, hiking, and historical insight into the southwest culture known as the Anasazi.

These are just some of the many opportunities to experience southwestern culture before or after the CDS. For additional information, check out the links on the IRES Web site. ■

The 2010 Career Development Seminar

New Mexico to IRES: *Welcome!*

Bill Richardson
Governor

State of New Mexico
Office of the Governor

A Welcome Message from Governor Bill Richardson

As Governor of New Mexico, it is a pleasure to welcome you to the Insurance Regulatory Examiners Society (IRES) 2010 annual Career Development Seminar, being held August 29 – 31, 2010, at the Hyatt Regency in Albuquerque, New Mexico.

I am pleased that you have selected Albuquerque for your annual Career Development Seminar (CDS). I understand that this is the Society's premier professional development activity with a series of workshops and panels covering a broad range of topics and issues pertinent to insurance regulation. It also provides an excellent opportunity to network with regulators and other insurance industry representatives.

In addition to keynote speakers, the seminar provides breakout sessions geared to those who work in many different areas of insurance regulations such as market regulation, consumer services, financial solvency, producer licensing and enforcement & compliance areas. The CDS also offers general sessions surrounding issues for life, health and property & casualty insurance as well as sessions discussing issues that cross functional units.

In spite of an intense agenda, I encourage you to enjoy the captivating natural beauty of our high desert landscape, endless skies and breathtaking sunsets which have inspired artists for centuries. There are many wonderful opportunities in and around Albuquerque to enjoy our wonderful arts and crafts from the southwest. Be sure to sample some of New Mexico's famous chile, so that when you leave you will be able to answer the official State Question: Red or Green?

Best wishes for a comfortable stay in the Land of Enchantment.

With warmest regards,

Bill Richardson

Bill Richardson
Governor of New Mexico

CITY OF ALBUQUERQUE

As Albuquerque's mayor, I would like to personally welcome the Insurance Regulatory Examiners Society to Albuquerque – the shining star of the Southwest. Prepare to be amazed by our rich culture, our unique heritage and our wonderful people.

I hope that your time in Albuquerque is productive as you meet for your annual Career Development Seminar on August 29 – 31, 2010. We look forward to having you in our city as you continue your work to promote fair, cost effective and efficient insurance regulation by ensuring professionalism and integrity among individuals who serve state and federal insurance regulatory bodies.

Your journey through Albuquerque can take you in many directions, and no matter what your interests are, the city has much to explore. Our spectacular climate – boasting all four seasons and 310 days of ample sunshine – sets the scene for hiking, biking, skiing or hot air ballooning above our majestic landscape. Enjoy an excellent collection of visual and performing arts, fascinating cultures and spectacular cuisine.

Experience a place where the modern city skyline is set against the backdrop of the ancient cultures of the Southwest. Immerse yourself in Albuquerque. You will be glad you did.

Sincerely,

Richard J. Berry
Mayor

PO Box 1293
Albuquerque
NM 87103
www.cabq.gov

IRES Chapter News

LOUISIANA — At our February State Chapter Meeting **Darin J. Domingue,** Deputy Chief Examiner with the Louisiana Office of Financial Institutions presented "Office of Financial Institutions – 101 – Who We Are and What We Do." In his presentation, Mr. Domingue discussed, among other things, depository and non-depository institutions, residential mortgage lending, multi-state licensing initiatives, and requirements for licensing. There were 22 attendees.

The Louisiana Chapter held another Chapter Meeting on March 19 before 20 attendees. **Joseph J. Gallo, Sr.**, Deputy Compliance & Ethics Officer with Louisiana Health Service & Indemnity Company (Blue Cross Blue Shield of Louisiana) addressed the group on compliance issues. Topics of discussion included the company's compliance program, tracking relevant laws and regulations, maintaining accurate records, and protecting confidential medical and financial information.

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

Hooray for Hazel!

Cheers, Tears for Hazel Mosby

Tears were shed on Tuesday, April 13 when the IRES Washington D.C. Chapter paid tribute to Hazel Mosby on her retirement after 23 years with the District of Columbia's Department of Insurance, Securities and Banking.

Fellow IRES members and co-workers showered Hazel with gifts and awards, including an IRES plaque, a letter from IRES President Dennis Shoop, and a Certificate of Appreciation from Washington D.C. Commissioner Gennet Purcell. Hazel retired from the Department on April 23.

Over the past decade, Hazel was a member of the IRES Board of Directors and served as the D.C. Chapter's State Chair. She was also actively involved in many of IRES' Career Development Seminars. We will all miss Hazel's quiet dignity, emphasis on professional growth and her unwavering faith.

Congratulations Hazel and *please* continue to actively participate in IRES.

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.

Regulatory Roundup

by Stroock & Stroock & Lavan LLP

Michigan – Senate passes bill to impede hostile takeovers of small insurers

On March 23, the Michigan Senate passed S. 1174, a bill amending the insurance law to require a two-thirds supermajority of shareholders to approve an outside entity's proposal to merge with or acquire control of a domestic insurer if the current board of directors opposes the takeover, but only for domestic insurers with 200 or fewer employees. The two-thirds supermajority requirement would apply to any proposal to enter into an agreement to merge with or otherwise control the domestic insurer or to merge with or control a "person" controlling the domestic insurer. (The term "person" includes "an individual, insurer, company, association, organization, Lloyds, society, reciprocal or inter-insurance exchange, partnership, syndicate, business trust, corporation, and any other legal entity.") A proposal that, for the purpose of obtaining control, seeks the election of two or more members of the board of the domestic insurer or of a person controlling the insurer would likewise be subject to two-thirds majority approval. The 200-or-fewer-employees requirement includes both those employed directly by the insurer, or indirectly through an affiliate transacting the company's business. According to published reports, the Bill was introduced in response to an attempted hostile takeover last year of Fremont Michigan InsurCorp., a small Michigan-domiciled insurer. The Bill was approved by the Michigan House of Representatives Insurance Committee on April 19, 2010. To view S. 1174, visit the Michigan Legislature's Web site at **www.legislature.mi.gov**.

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.

New York — Insurance Department publishes proposed regulation prohibiting "discretionary clauses" in policy forms

On April 14, the New York Insurance Department issued draft Proposed Regulation No. 184 (11 NYCRR 222), which would prohibit the use of "discretionary clauses" in any policy form issued or delivered in New York. A "discretionary clause" is defined under the Proposed Regulation as a provision in the policy that grants the insurer (or a plan administrator or claims administrator) the discretionary authority to determine eligibility for benefits, resolve disputes, or interpret the terms and provisions of the policy or develop standards of interpretation or review. The Proposed Regulation noted several federal court decisions which held that if a policy form contains a discretionary clause, a court cannot interpret the provisions of the policy *de novo*, and would be limited in its review to whether the decision or interpretation of the insurer was arbitrary and capricious.

In the Insurance Department's view, this limited standard of review would give the insurer wide discretion, which can serve to negate essential provisions of policy forms and render coverage illusory. The Insurance Department therefore determined that discretionary clauses are contrary to Sections 3201(c) and 4308(a) of the Insurance Law, which authorize the superintendent to disapprove a policy form if it is "prejudicial to the interests of policyholders or members or it contains provisions which are unjust, unfair or inequitable" or if its provisions "encourage misrepresentation or are unjust, unfair, inequitable, misleading, deceptive, or contrary to law or to the public policy of this state." The Proposed Regulation was open to public comment until May 5, 2010 and would apply to every policy issued 60 days after the effective date thereof. To view Proposed Regulation No. 184, visit the New York Insurance Department's Web site at **www.ins.state.ny.us**.

Casual Observations

Translating Credit Default Swaps

When we first heard of credit default swaps (CDSs), we couldn't figure out how these derivatives differed from your standard insurance contract. Well several years have passed, and we're still trying to figure it out.

Even more mysterious is the *synthetic* collateralized debt obligation (CDO), a product that depends on credit default swaps for its very existence.* (A note of caution: Before proceeding, we strongly suggest you read the footnote.)

Credit Default Swaps

In a typical CDS, a bond owner seeks to address the risk that the bond issuer may default. To mitigate such risk, the owner agrees to buy a CDS (insurance world translation: *policy*) from a CDS seller, agreeing to make payments (*premiums*) to the seller. In exchange for these payments, the seller agrees to pay the unpaid principal and accrued interest to the purchaser (*agrees to indemnify the policyholder*) in the event the bond defaults.

One obvious difference between a CDS and an insurance policy is that CDS sellers need pay only scant attention to such trifles as reserves. Our guess is that in the CDS world, adequate reserving is considered just another outmoded 20th Century concept, best left to stodgy insurers and pension funds.

Few risk managers would allow their firm to purchase a commercial multi-peril policy through a property/casualty insurer that fails to properly reserve, yet "sophisticated" buyers routinely purchased credit default swaps from parties who clearly were in no position to make good on these contracts should the "perfect storm" arise.

Synthetic CDOs

In a synthetic CDO, credit default swaps are packaged together into a portfolio so that buyers can purchase portions of that overall risk without necessarily owning the reference securities (such as mortgage bonds or regular CDOs). Each credit default swap's role in a synthetic CDO could be described this way: The "short" CDS investor agrees to pay the interest payments that normally would be generated by the underlying security. In the event that security defaults, the "long" investor must pay a sum of money to the "short" investor.

Remember, neither the buyer nor the seller of a synthetic CDO typically has an economic interest (insurance world translation: *insurable interest*) in the collateral assets.

Simply put, it's a gambling device. The question is whether we really need such devices? Do they provide any economic or societal value? After all, no insurer would allow you to buy fire insurance on your neighbor's house or insure your neighbor's life.

Some would argue that the selling of synthetic CDOs represents nothing more than a zero-sum game, i.e., for every loser, there's a winner. But if the losers receive taxpayer bailouts after making those bad bets, then don't we all end up losing? And shouldn't gambling be left to the casinos so that investment banks can focus on offering products of real value?

We're glad that the vast majority of insurers were not permitted to write CDSs. We're also pleased insurers and regulators have always recognized the difference between an insurance contract and a gambling contract.

We'll always have a fond place in our heart for adequate reserving, maintaining the insurable interest principle, and — to really conjure up an outmoded 20th Century concept — *acting responsibly.*

— *W.C.*

* Lenders or third parties frequently package up individual loans into mortgage-backed securities (MBS) and sell them to investors. Often these MBS are bundled along with other MBS by yet another party who creates an instrument known as the collateralized debt obligation (CDO), designed to be even more diversified than an individual MBS. A synthetic CDO is a package of credit default swaps on securities such as CDOs. Confused yet?

Albuquerque

2010 IRES Career Development Seminar

AUGUST 29-31, 2010 HYATT REGENCY

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

Registration Form

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

Name

Title   First name for Badge

Insurance department or organization

Your mailing address   Indicate: ☐ Home ☐ Business

City, State, ZIP

Area code and phone $ Amount enclosed or pay online

SPECIAL NEEDS: If you have special needs addressed by the Americans with Disabilities Act, please notify us at 913-768-IRES (4737) at least five working days before the seminar. The hotel's facilities comply with all ADA requirements.

SPECIAL DIETS: Only those requesting a special dietary meal in advance will have one available during the CDS.
Circle: Diabetic Kosher Low salt Vegetarian

Seminar Fees

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

Check box that applies

- ☐ IRES Member (regulator)............. $330
- ☐ Industry Sustaining Member.......... $550*
  *REQUIRED: Sustaining Member # SM________
  Lost your number? Send e-mail query to : ireshq@swbell.net
  Provide company name and contact information.
- ☐ Retired IRES Member.................. $125
- ☐ Non-Member Regulator............... $470
- ☐ Industry, Non-Sustaining Member $940
- ☐ Student Sustaining Member............ $80
- ☐ Spouse/guest meal fee.................. $80

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.

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

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What's Inside

Recession Hits
Some States Hard

BULLETIN BOARD

✓ Wesley Mark Arbeitman, CIE, passed away April 12. He had been a member of IRES since 1989 and was a market conduct examiner for the Missouri Department of Insurance for 19 years.

✓ The governor of New Mexico has his eye on the 2010 IRES CDS. So does Albuquerque's mayor. See page 15.

✓ Good luck, Hazel Mosby. See p. 16.

✓ IRES member Lynette Baker of Ohio is this year's recipient of the Paul DeAngelo Memorial Teaching Award. The award is presented annually by the IRES Foundation to a regulator or former regulator who has demonstrated an extraordinary commitment to insurance education. Lynette is a division chief of the Ohio department's Market Conduct Division.

✓ Looking for a new career? Be sure to check out the job listings on the IRES Web site, www.go-ires.org.

In the next REGULATOR:

Albuquerque CDS Preview

Conducting IT Exams

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.