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# nolhga journal

A Publication of the National Organization of Life and Health Insurance Guaranty Associations

# Place Your Bets

## NOLHGA's Annual Meeting gives attendees a glimpse of what the future might hold for the guaranty system

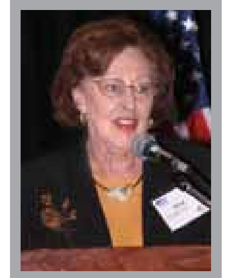
By Sean M. McKenna

In his President's Address at NOLHGA's 2004 Annual Meeting, Peter Gallanis likened his remarks to a State of the Union address for the guaranty system. He noted that the Constitution calls for the president to make the State of the Union address "because America changes each year, and because the global environment changes each year." The "global environment" surrounding the insurance industry, regulatory community, and guaranty system, he added, certainly saw its fair share of changes in the past year (highlights from the President's Address can be found on p. 2).

The changes the industry witnessed in 2004—including the growing prospect of radical changes to insurance regulation and the recent investigation into industry practices launched by New York Attorney General Eliot Spitzer—formed the backdrop for NOLHGA's 2004 Annual Meeting, which was held on October 26–27 in Las Vegas, Nev. More than 160 attendees heard speakers from the insurance industry, regulatory community, and academia discuss the possible impact of these and other challenges on the industry and guaranty system. Although many of the speakers had differing opinions on where the industry and the regulatory structure surrounding it are headed, all agreed on one thing—the changes are just beginning.

### Ethics & Federal Regulation

Alice Molasky-Arman, commissioner of the Nevada Division of Insurance, provided the welcoming remarks for the meeting and also offered a heartfelt tribute to the late Ben Dasher (former chair of the Nevada Life & Health Insurance Guaranty Association), expressing her great admiration for his skill and that of his successor, Linda Ogle.


Alice Molasky-Arman

Molasky-Arman also outlined her department's efforts in battling what she called a "major catastrophe" in the insurance industry—insurance fraud, which she said resulted in $80 billion to $120 billion in losses each year. To combat fraudulent insurers, the division has mounted a public relations campaign aimed at educating small employers on the dangers of doing business with unlicensed insurers. Molasky-Arman reported that the campaign—which uses billboards, brochures, and a Web site (www.nvinsurancealert.com) — has received "an enormous response." Similar initiatives have been adopted in other states, and the NAIC has instituted a national consumer-awareness campaign called "Fight Fake Insurance."

Talk turned from fighting fraudulent insurers to the importance of ethics among reputable insurers in the meeting's next

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## Teamwork, Uniformity Highlight Chairs' Addresses

The theme of NOLHGA's 21st Annual Meeting was "Taking the Next Steps," and in their addresses to the membership, Outgoing Chair James R. Mumford and Incoming Chair Ronald G. Downing made it clear that the next steps for the guaranty system must include enhanced teamwork and uniformity if the system is to adapt to changes in insurance regulation.

Outgoing Chair James R. Mumford

In his address, Mumford singled out the Guaranty System Modernization Task Force (which he co-chairs with MPC Chair Jack Falkenbach) and the many who have assisted the task force in its work, saying "we've done quite a bit, but I don't think we've done enough." The reason for this, he added, is that the guaranty system community has not thrown all its weight behind efforts to modernize the system.

Modernization is necessary, Mumford explained, because both the insurance industry and insurance regulation are changing. This being the case, he said, "it would be foolish to

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Incoming Chair Ronald G. Downing

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# Taking the Next Steps

*The following is adapted from the President's Address given at NOLHGA's 21st Annual Meeting on October 27, 2004.*

A week before this meeting, my dear friend Bob Ewald, whom I am delighted to see here again today, made some observations about the nature of our guaranty system, comparing some of its structural components to components of the American system of government.

His comments led to this question: Is this address, which my predecessors and I have been called upon to deliver at each annual meeting, roughly analogous to a "State of the Union" address for the guaranty system? While I confess I never thought of it that way before Bob's notes, that is a useful simile.

We expect our American presidents to deliver a State of the Union address each year—the Constitution calls for it—because America changes each year, and because the global environment changes each year. Americans want and need to hear how changes will affect them, and what the country must do to harness change and prosper from it, or at a minimum to avoid harm threatened by a changing environment.

Applying those same drivers to our discussion today, let's talk about some of the changes that directly confront our system, as well as changes in the broader business, industry, economic, and political environments that have significant implications for us all. Then let's consider some of the things we may do to address those changes—some of the *next steps* that we should take.

## Industry Economic Considerations

My first brief area of comment has to do with the economy as it relates to the life and health industry, and I won't dwell on that for long. While we aren't completely out of the woods yet, the "perfect storm" economic conditions we confronted two years ago have significantly abated. In 2002, the economy generally and the life industry specifically were under intense pressure from the recessionary conditions that then obtained, a depressed stock market, terrorism concerns, widespread defaults on corporate bonds, and an investor confidence crisis in the wake of perceived corporate fraud and malfeasance.

Not all of those concerns have vanished, but the general economic conditions of 2003 and early 2004 showed significant improvement in most of those areas. As a result, industry operating results in 2004 were generally better; industry total capital rose to record levels; and NAIC risk-based-capital numbers for the industry rose to "high-water-mark" levels.

While the current picture is not entirely rosy—spread compression from continued low interest rates remains a problem, as does accurately quantifying and managing risk from the growing use of a variety of "embedded guaranties" in annuity and universal life products—the picture at least is not as ominous as it was two years ago. Many companies will continue to face ratings downgrades, and pressures to consolidate will continue. But the risk that general economic pressures will precipitate a wave of insolvencies like what we saw in the early 1990s seems to have abated.

One other pending solvency story may have a political impact on our system, and that is the continuing troubles of some major property/casualty carriers. We must monitor that situation for two reasons. First, CEOs of large property/casualty companies have expressed dissatisfaction in the past year with both the solvency regulation of insurers in their industry segment and with the property/casualty guaranty system. To the extent that viewpoint is adopted by Capitol Hill decision makers, it may undermine our efforts to promote a positive view of the life and health guaranty system. In addition, that challenge would be even greater if guaranty system capacity problems—or even material risks of inadequate capacity—are perceived on the property/casualty side of the industry.

## Regulatory Reform Efforts

Turning back to the life industry, the trend continues for life companies to write more and more business that is *not* traditional, "plain vanilla" life insurance—in short, business with "investment" characteristics. One consequence is that, increasingly, life insurers are competing head-to-head with banks, mutual funds, and securities firms. Those firms operate under a federal regulatory system that most life insurers would describe as more responsive, quicker, and cheaper than the state insurance regulatory system.

Consequently, many insurers believe they need a more efficient, responsive regulatory mechanism to survive in a very competitive business environment. As we heard from NOLHGA Chair Ron Downing earlier today, the call to achieve that goal through optional federal chartering continues, as much from small companies as from large companies. From other sectors of the industry we have heard demands—as recently as last week—not only for a federal chartering option but even for abandoning the existing state-based insurance guaranty system and turning the entire safety net function over, on a pre-funded basis, to the FDIC.

If it is a fact of life that many insurance companies and banks continue to press for optional federal chartering for insurers, it's equally a fact that Congress hasn't yet bought the idea. Leadership of the House Financial Services Committee has recently circulated a draft bill on insurance regulatory reform—the "SMART Bill"—and that bill does not provide for optional federal chartering.

Over the past two years, the House has held a number of hearings on regulatory reform, and concerns and objections about federal chartering proposals were expressed by some insurance brokers, some companies in the property/casualty sector, and a number of state legislators and insurance commissioners. House leadership and staff appear to desire a cautious, "incrementalist" approach, preferring the "federal standards" approach of the SMART Bill proposal to life industry calls for optional federal chartering—at least for now.

## The Impact of the Spitzer Investigations

Under normal circumstances, one would expect that the debate in Congress would proceed on a fairly linear path based on the starting point represented in the SMART Bill proposal that is currently circulating. I wonder, though, whether circumstances have not recently, and radically, changed—whether the normal, linear path of the policy discussion hasn't been knocked into an entirely different line.

Judging from media stories of the past two weeks, we might be justified in wondering whether October 14, 2004, was a date of such

seismic significance that eventually it may be referred to, at least in the industry, in nearly the same tones now reserved for September 11 and December 7. On October 14, New York Attorney General Eliot Spitzer filed a civil complaint against the brokerage firm Marsh & McLennan in which he alleges that Marsh and some of the insurers with which it placed business had engaged in a variety of improper business practices involving compensation to the broker by the insurers that was undisclosed (or inadequately disclosed) to the insureds; the complaint also alleges that "bid-rigging" took place in the solicitation of coverages.

The ripple effects of Spitzer's complaint were immediate and profound, and we have no way now of telling where they will stop. Let me mention a few of the effects we've seen so far. First, the financial impact of this lawsuit—which may or may not be permanent—is staggering. Shares of stock in the Marsh firm itself, which is publicly traded on the New York Stock Exchange, had by the end of last week lost half their value since October 14. Many of those shares are owned, in retirement accounts or otherwise, by the 60,000 Marsh employees. Share values of a number of other companies mentioned in connection with this story have also declined, if not as drastically. If the situation worsens materially, some of the parallels to Enron, which have already been drawn in *The New York Times* and *The Wall Street Journal*, will grow in frequency and volume.

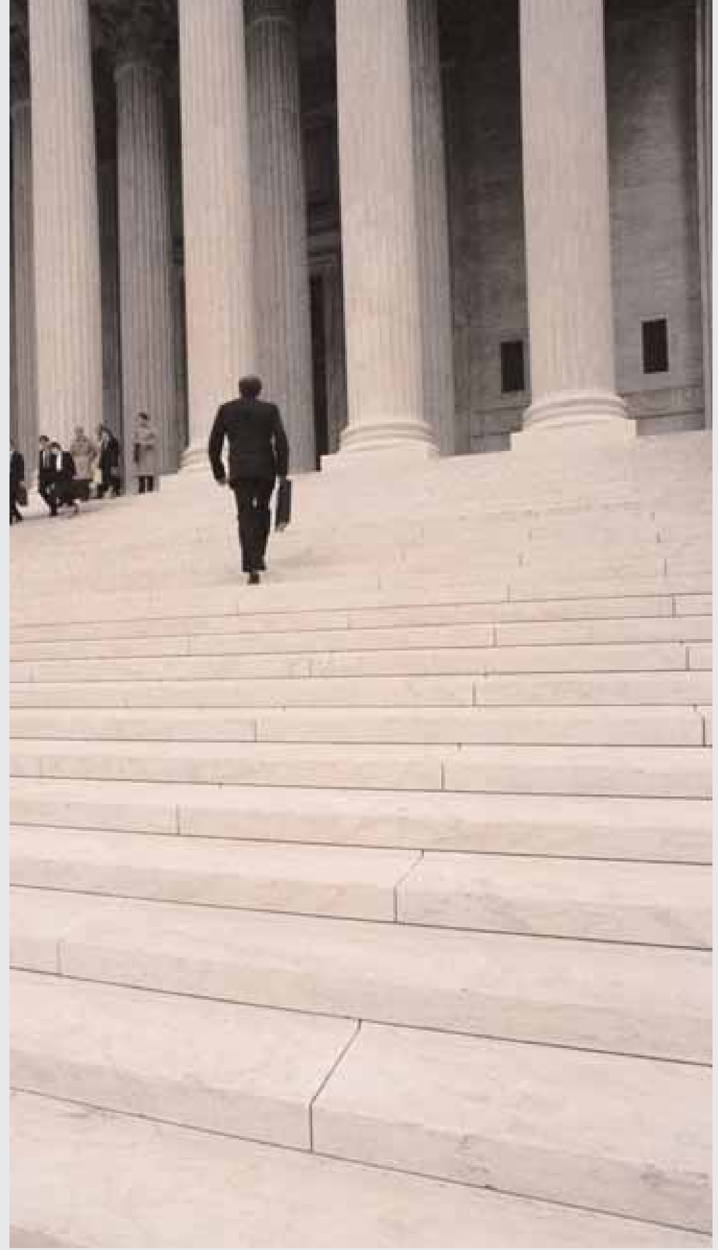
But even at this early date in the investigations, the insurance industry has become the focus of an unprecedented level of critical review, and the review has not been restricted to the property/casualty brokerage practices that were at the core of Mr. Spitzer's October 14 complaint.

Within days, Mr. Spitzer, other state attorneys general, and various insurance commissioners announced inquiries into a variety of industry marketing practices and products. For example, brokerage practices for group health coverages are now being reviewed in California, and brokerage regulations have been proposed in that state that are so strict that one can see a potential for violation in every contract placement, good or bad. Group life has also been mentioned as an investigatory target. A federal grand jury is looking at transactions whereby an insurer reportedly engaged in transactions that may have masked adverse financial developments for other companies. Antitrust "tying" violations are being discussed. Other brokers—large and small—and writers of insurance and reinsurance have become embroiled in the investigations. Corporate indictments have been mentioned. The NAIC is reported to have held conference calls to discuss further regulatory actions that may be pursued. Class-action lawsuits are clearly in the offing. Congressional hearings in the near future are a certainty.

In short, the blood is in the water, and the sharks are circling. Media observers have opined that the industry will never again be viewed as it was before Mr. Spitzer's efforts. Others suggest that the record of practices alleged by Mr. Spitzer fundamentally calls into question the viability of state insurance regulation.

Whether or not those statements are premature (and they may be), at least for the short term the Spitzer allegations have dramatically diverted the attention of both Congress and the states from the regulatory debate that was being conducted before October 14, and the future of that debate may also be redirected.

Will the producer community and certain property/casualty insurers carry the same clout in Congress in the wake of these claims? Will state



legislators and regulators be given the same deferential treatment they have received in recent House hearings? Will Congress, over the objections of almost all of the previous participants in the regulatory reform debate, act precipitously in reaction to today's headlines (as some say Congress did in enacting the Sarbanes-Oxley legislation) and enact previously undebated, sweeping regulatory reforms?

And speaking of Washington, there is the minor matter of the upcoming November 2 elections; how will these policy debates be affected in the event that the levers of federal and state power are controlled by different hands? For now, it seems clear that the political waters through which we sail are troubled in ways we haven't seen since the early 1990s.

## NAIC Developments

The Spitzer lawsuit and its after-effects may be the most significant recent political development for the industry, but there are other important recent developments. Two significant projects directly affecting guaranty associations are continuing at the NAIC, and their successful conclusion is very important to us all. The first is a longstanding project to rewrite the NAIC model act governing insurer rehabilitations and liquidations. The second is the development of a white paper encouraging enhanced coordination and communication among regulators,

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receivers, and guaranty associations as troubled companies enter the zone of likely insolvency.

*Receivership Model Act Revisions.* The NAIC's Model Act Revision Working Group has been working for several years now to rewrite the current receivership model act. The work has accelerated in the past several months, driven both by a desire to meet an NAIC goal of completing the project this year and also by perceived pressure from the SMART Bill.

The debates over receivership model act revision have been long, detailed, and sometimes convoluted. A variety of proposals have been proposed, discussed, revised, and re-revised. Along with other interested parties, NOLHGA (largely through the efforts of Senior Counsel Joni Forsythe) has contributed significantly to the debates.

The guiding philosophy for NOLHGA's comments has been that insurance receiverships exist for only one primary purpose: to distribute assets of an insolvent insurer expeditiously, efficiently, and fairly to those who have valid claims against the insolvent company. Accordingly, NOLHGA and other participants in the discussion have ascribed a great deal of importance to accountability and transparency issues in receivership proceedings by supporting substantive and procedural rights to receivership stakeholders that in some cases are not provided under the current NAIC receivership model act.

Ultimately the NAIC—meaning the commissioners—will have to make hard choices concerning the balance between receivers' administrative convenience and transparency and accountability to the stakeholders whom the receivership system is supposed to serve. If the same virtues the NAIC espouses in other efforts to modernize state regulation are applied to the receivership statute, then the ultimate product could be a model act of which state insurance commissioners justly could be proud.

**"…there is always room to improve, and this is not a time for us to rest, even on well-deserved laurels."**

*White Paper on Cooperating and Coordinating Activities with Guaranty Associations.* Another NAIC project involving the guaranty system has benefited greatly from guidance provided by NAIC leadership and some of that group's most visionary commissioners. I am speaking of the white paper now nearing completion that articulates the appropriate considerations that should govern communications and cooperation among regulators, receivers, and the guaranty system when a company is in material danger of insolvency.

On this project, NAIC leadership has recognized the direct benefits to the consumers we all serve of having protocols for early warning and insolvency contingency planning that will allow guaranty associations to "hit the deck running" if and when an insolvency occurs. This project was first conceptualized in remarks made to a NOLHGA Annual Meeting several years ago by Arkansas Insurance Commissioner and then-NAIC President Mike Pickens, and I am pleased that the project is now nearing a successful conclusion. This success follows a long and very positive dialogue between NAIC leadership—and especially New Jersey Commissioner Holly Bakke—and the guaranty systems, in which we have successfully addressed a number of the very issues that you heard Art Dummer raise in the discussion yesterday about guaranty system modernization.

I love to see successes like this in state insurance regulation, because I consider my own professional career a product of state insurance regulation. I am a longtime supporter of robust and effective government at the state level. The advocates of optional federal chartering may or may not someday get their wish, but even if they do, state insurance regulation will remain with us (just as state banking regulation does today). I applaud the Pickens initiative, as I have many other successes in state insurance regulation.

## Taking the Next Steps

If I have correctly identified some of the more important factors that may now loom on the horizon for the life and health industry and for our member guaranty associations, the question then becomes what can we—and what should we—do in light of these challenges? Given where we are, what are the next steps we should take?

Let's consider what our friends in the regulatory community have done. Several years ago, when George Nichols was president of the NAIC, he set the NAIC on a course of regulatory reform and modernization that is still being pursued by that organization. The NAIC deserves praise for recognizing and acknowledging from that time on that the same disciplined, searching, critical self-examination process that good businesses everywhere have been applying to themselves also must be employed by the NAIC and to the overall enterprise of state insurance regulation. A lot of good has come from that initiative, begun by President Nichols and continued by subsequent NAIC opinion leaders, including, among others, our good friends Mike Pickens, Nat Shapo, Teri Vaughan, Ernie Csiszar, and Commissioner Walter Bell, from whom we'll hear later today.

The NAIC leadership's push for regulatory modernization reflects a simple precept: All organizations are accountable to their stakeholders, and an organization that does not strive to improve itself and find better and more effective ways to serve its stakeholders is, in effect, moving backwards. The NAIC's leadership has made a commitment to critical self-examination and to improving that organization's performance on behalf of its stakeholders.

As I have listened to discussions at our general sessions and in the hallways here over the past two days, I believe I have heard the membership of this organization express a very similar sentiment. The thrust of that sentiment is that we have a job to do on behalf of the stakeholders of this system. It's a hard job, though one that historically we have done very well. But there is always room to improve, and this is not a time for us to rest, even on well-deserved laurels.

Some of our invited guests offered some insights yesterday about things we need to do that we have already commenced. For example, Professor Bair mentioned some concrete "selling points" about this system that she feels must be conveyed to Congress and to other potential critics of our system—points about our solid historical performance in protecting consumers, our financial ability to meet our obligations, and our cost-effectiveness. The good news is that, through our education efforts, we have made a great start on that score, but we have much yet to do.

In explaining some of the steps that have been taken by the Insurance Marketplace Standards Association to help good companies establish that they are applying proper marketing standards, former NAIC President

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# A New Receivership Law

## The NAIC's work on an updated model receivership law is almost complete.

**By Joni L. Forsythe**

The NAIC's Model Act Revision Working Group is nearing completion of its work on a multi-year effort to produce an updated and revised draft of the NAIC's model receivership statute.

The working group was charged with producing a revised model receivership statute using the current NAIC Model Insurers Rehabilitation and Liquidation Act as a starting point and incorporating provisions of the Uniform Receivership Law, as adopted by the Interstate Insurance Receivership Commission in 1998. Work on this project began in early 2001, and the revised draft is now expected to be finalized for NAIC review and action by mid-June 2005. The proposed 2005 model represents a comprehensive rewrite of the NAIC's current Model Insurers Rehabilitation and Liquidation Act. Upon completion, the model will be cited as the NAIC's Model Insurer Receivership Act.

NOLHGA has been an active participant in this project throughout the process, providing, in consultation with NOLHGA's Legal Committee, both verbal and written input, comments, and suggestions. Our involvement has been focused upon bringing the guaranty association perspective to the table to protect the rights and further the interests of the guaranty association community.

In June 2004, the NAIC released a preliminary compilation of proposed model revisions. It also unveiled its proposal to Congress for including the newly revised model as an accreditation standard for the states as part of the current federal regulatory reform effort. This latter development increased the pressure on the working group to complete the process of developing the model as quickly as possible.

By the September 2004 NAIC meeting, the working group reported completion of just over half the model provisions. The group also reported plans to expedite the review of the remaining provisions by conducting twice-weekly teleconferences going forward and holding an additional two-day, in-person review and drafting session; the goal was to have the draft model completed before the December 2004 NAIC meeting. At the December meeting, the working group reported that drafting was approximately 95 percent complete and that the group would continue conducting twice-weekly teleconferences throughout December and into January 2005, as needed, to complete its charge.

The efforts of the working group are expected to be completed by the end of January so that a final draft can be presented for approval to the NAIC's Receivership and Insolvency Task Force and then submitted for approval to E-Committee by March, with the expectation that the draft would be queued up for final NAIC approval in connection with the June NAIC meeting. With this timeframe in mind, the NAIC is soliciting input and comments on the current draft from interested parties at this time.

NOLHGA will continue to closely monitor developments with respect to the proposed model and provide comments and suggestions, as appropriate. Given the comprehensive nature of the changes made to the model, and the fact that the NAIC has stated its intent to make adoption of the new receivership model an accreditation standard for the states, we also encourage interested parties to review the proposed draft and provide any input or comments they may have.

Updated drafts of the revised model are posted on the NAIC Web site (www.naic.org) periodically under the link for "Insolvency Task Force and Working Group Activities" (go to the "Members" section of the site and select "Receivership Information"). These drafts include instructions for submitting comments to the NAIC within the document headers. You may also request a copy of the most current draft by contacting Aimee Frye at NOLHGA (703.787.4115). ✯

*Joni L. Forsythe is senior counsel for NOLHGA.*

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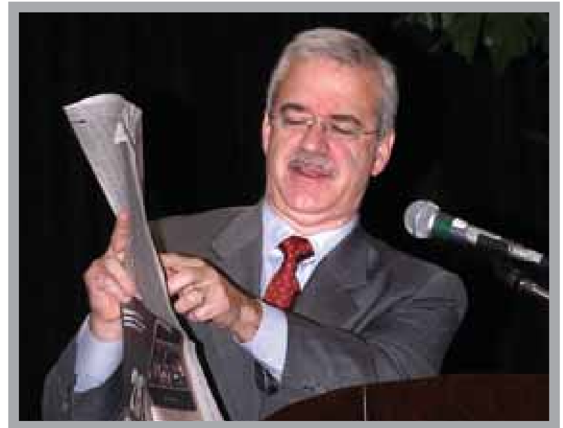
presentation. Citing the Spitzer investigation, Brian Atchinson, executive director of the Insurance Marketplace Standards Association, noted that "the recent spotlight on our industry is a powerful reminder that ethical business practices are more than just the right thing to do—ethics is a bottom-line issue for the insurance industry."

According to Atchinson, the value of doing business the right way is clear, especially in the insurance industry, which is based on consumers' trust and confidence. "It takes many years to grow a reputation and a short time to tarnish one," he said. "Commitment to ethical business practices is a good way to manifest your commitment to your stakeholders."

Atchinson noted that regulators play a vital role in preserving the public's trust in the insurance industry by creating a competitive marketplace and protecting consumers. However, the regulatory community's effectiveness has come into question, he said, citing a 2003 report by the Government Accountability Office indicating that state regulation failed to provide adequate consumer protection and saddled the industry with added costs.

This report and other factors have led to heightened activity in the regulatory community. Atchinson pointed to the NAIC/NCOIL Model Market Conduct Act, the NAIC's Framework for Regulatory Reform, and the draft of the new State Modernization and Regulatory Transparency (SMART) Act released by the House Financial Services Committee. The SMART bill, which would establish uniform standards for state regulators, is where most of the action is, Atchinson said, and all interested parties



Brain Atchinson, executive director of the Insurance Marketplace Standards Association

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think that the guaranty system can remain the same." He went on to say that "the biggest threat to the guaranty system isn't an optional federal charter, the SMART bill, or even interference from Capitol Hill—it's complacency."

The guaranty system will eventually be called on to meet minimum standards of efficiency and uniformity, Mumford said, and he called on its members to "band together for the betterment of the guaranty system and those it serves."

Downing also sounded the theme of adaptation in noting that his company, like many other smaller insurance companies, is an enthusiastic supporter of an optional federal charter—an idea "that could very well mean the end of the state-based guaranty system," he said, since many insurance industry CEOs would be willing to accept a federal guaranty system in exchange for the charter.

While a federal charter could mean the end of the state-based system, Downing doesn't believe it will. "The guaranty system can adapt as it has to other changes in the regulatory environment," he explained. The key, he said, lies in "enhancing communication, coordination, and uniformity among the guaranty associations…to prepare the system to deal with some kind of federal oversight."

Downing acknowledged that the move to increase uniformity in areas such as assessments, coverage, and even the creation of Web sites for every guaranty association would be challenging, but he stressed the need to "standardize those areas of our operations that will make us more efficient and valuable to the people who matter most—policyholders." Achieving this standardization while working to maintain the elements of the state-based system that best serve policyholders, he said, is the surest way to forestall any calls for a federal guaranty system. ✯

Outgoing Chair James R. Mumford accepts a gift of recognition from Incoming Chair Ronald G. Downing.

## NOLHGA's Blue Suede Shoes

NOLHGA's 21st Annual Meeting featured its usual mix of business and pleasure—and a chance to rub elbows with one of Las Vegas's most famous residents.

need to take it seriously. "There's a bill in play on the field, and anyone who doesn't keep their eye on it does so at their own peril."

Sheila Bair (Dean's Professor of Financial Regulatory Policy at the University of Massachusetts—Amherst Isenberg School of Management) offered her insights into the likelihood of federal insurance regulation as she discussed the findings of a study by the Isenberg School of Management on consumer ramifications of an optional federal charter (see "The Federal/State Debate," *NOLHGA Journal*, September 2004). She noted that the study indicated that state regulation has resulted in significant "front-end" costs (producer and company licensing, product approval) to companies but less emphasis on "back-end" regulation (financial and market conduct exams and regulation). In addition, smaller companies bear a disproportionately higher burden in dealing with regulatory costs, and many companies reported a large amount of lost premium income due to delays in licensing and approval.

Bair said that redundant filings create a large workload for state insurance departments, resulting in a decreased emphasis on market conduct exams, which are conducted "on a much less frequent basis than solvency exams." She predicted that Eliot Spitzer's investigation of various insurance company practices (such as contingent commissions) "is really going to provoke debate over the weakness in market conduct oversight" and will "heighten the federal debate" over insurance regulation.

This debate, Bair explained, currently centers around three options for regulation: maintaining the status quo, creating an optional federal charter, or enacting the SMART bill. The status quo option is the least likely, but the other options pose problems as well. An optional federal charter "has stiff political opposition" from insurance agents as well as regulators, and the argument that a federal regulator could be too remote to adequately serve consumers "is an important issue that needs to be thought about," Bair said. The SMART bill also faces political oppo-

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Sheila Bair, Dean's Professor of Financial Regulatory Policy at the University of Massachusetts—Amherst Isenberg School of Management

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sition (though Bair expects it to be passed by the House in 2005), and it lacks an enforcement mechanism. What's more, "it's really not a permanent solution," Bair said, since it requires a progress report to Congress in three years.

Despite the varying approaches to regulatory reform, "there's a strong consensus that there needs to be national, uniform standards," according to Bair. These standards do not necessarily have to be federal standards, however. She added that in her opinion, the federal government does not want to create a federal guaranty system at this time, but she also acknowledged that if a federal charter is created, "Congress is going to want minimum federal standards" for the guaranty system.

## Busy Regulators

The changing nature of insurance regulation was also on the mind of William Goodyear, chairman and CEO of Navigant Consulting, Inc. (see "The New Regulatory Age," p. 13). He argued that recent changes in regulation are nothing new, so to speak. "Change has always been with us," Goodyear said, while granting that "the velocity is up, there's no question about that." The most significant change in regulation, he added, is that it has become more active and more competitive among federal, state, and local regulators.

Alabama Commissioner of Insurance Walter Bell

The driving force behind these changes is "an almost complete loss of regulatory and public trust vis-à-vis the business community," Goodyear explained. "There's a sense that things have gone awry." This, plus a growing movement toward consumer empowerment, has led to a sense that traditional business models are not constructed to give a "fair shake" to consumers. This in turn has resulted in a regulatory climate that demands increased levels of transparency and accountability and also promises potential criminal prosecutions as well as regulatory sanctions when wrongdoing is detected.

The keys to surviving this turbulent regulatory climate, Goodyear said, include increased corporate transparency, demonstration of compliance and document controls (in particular, he stressed the importance of strict policies on electronic communications), and an effort to anticipate regulatory change as much as possible. While he expressed confidence that the insurance industry would weather the current regulatory "storm," he also said that "we're going to have a very interesting two or three years."

Turning to regulatory change on the state level, Alabama Commissioner of Insurance Walter Bell gave attendees an overview of the origins of the NAIC's Interstate Compact and the progress made in enlisting states to participate. The compact is designed to create a single point of filing for product approval using uniform national standards. A commission would approve certain products (life insurance, annuities, disability income insurance, and long-term care insurance) using product standards created by participating states, and approval by the commission would constitute approval by the states.

Bell emphasized that "without uniformity, we're wasting our time trying to modernize the system." He added, however, that this uniformity could be achieved by state regulators without federal intervention and that, in his opinion, the federal government would prefer not to be in charge of insurance regulation.

The main driver behind the compact, Bell said, is increasing speed to market by offering the industry a "one-stop shop approach." The compact would also allow state insurance departments to reallocate their resources toward market activity regulation,

## Annual Meeting Presentations Online

A number of the presentations given by speakers at NOLHGA's 2004 Annual Meeting are available on the NOLHGA Web site in the "Events" section (www.nolhga.com/events/main.cfm). Just go to the "Annual Meetings" portion of the page and select the 2004 meeting dates, then hit "Go" to be taken to the meeting page, which has PDF files of the presentations.

## Politics on the Menu

Political commentator and columnist Mark Shields got the meeting off to a rousing start at NOLHGA's Welcome Luncheon, providing a humorous and insightful look at the American political scene and the 2004 presidential election. Calling Americans "the most optimistic people on the planet," Shields explained how that optimism played out in recent political campaigns and also explained how the nature of the presidency has changed since the 9/11 attacks.

Brad Smith, chair of Milliman USA

consumer complaints, and anti-fraud efforts. Once 26 states (or 40 percent of the premiums for life insurance, annuities, disability income insurance, and long-term care insurance) join the compact, the commission will become operational.

Brad Smith, chair of Milliman USA, also discussed possible improvements to existing regulatory requirements, in particular Regulation XXX. After warning that "actuaries don't have all the answers," he explained how older mortality tables failed to take into account the improving health of the general population. "The actuaries who monitor this basically missed the trend," Smith said.

Regulation XXX, he explained, employs inaccurate mortality expectations and conservative reserve rates to specify how much capital insurance companies must keep in reserve. This has resulted in what Smith called "massive over-reserving," which increases the cost of capital for insurance companies. In Smith's opinion, the reserve requirements for companies should be reduced so that some of this capital can be put to better use. ✯

*Sean M. McKenna is NOLHGA's director of communications.*

# The *SPITZER EFFECT*

**By Meg Melusen**

"*My study of this insurance brokerage controversy convinces me that there is a federal role—the time-honored federal role that guarantees competition and fights the mischief of undue market concentration."* With these words, retiring U.S. Sen. Peter Fitzgerald (R-Ill.) set the tone of the November 16, 2004, Senate oversight hearing looking into brokerage compensation practices in the insurance industry and the impact of those practices on insurance consumers.[1]

The hearing, conducted by the Senate Committee on Governmental Affairs, was scheduled in the aftermath of New York Attorney General Eliot Spitzer's lawsuit filed on October 14, 2004, against Marsh & McLennan Companies of New York, the nation's leading insurance brokerage firm. With dramatic accusations of widespread fraud and the splashy headlines typically drawn by Spitzer, the lawsuit is considered nothing short of an attack on the insurance industry as a whole.

Previous Spitzer investigations—Spitzer is well-known for his recent high-profile investigations of securities firms and mutual fund companies—have led to widespread changes in trade practices and new regulations in the mutual fund industry and on Wall Street. Given Spitzer's track record for catalyzing reform, the question becomes, where will his attack on the insurance industry lead?

# Will the insurance brokerage scandal speed or slow the march of insurance regulatory reform?

### The Suit

The lawsuit against Marsh & McLennan and others filed in its wake accuse the largest insurance brokers in the country of routinely defrauding their customers in an effort to secure lucrative fees well beyond the compensation structure of traditional sales commissions paid by their clients.

Typically, large companies with complex insurance needs hire brokers to act as middlemen between themselves and the insurance companies. The broker is expected to collect a number of insurance quotes for the client in an effort to provide the best deal for the buyer. In turn, the buyer pays a commission to the broker—usually a percentage of the insurance premium.

According to Spitzer's complaint, his office discovered internal e-mails and memos at Marsh & McLennan demonstrating that insurance brokerage executives actively worked to maximize income for themselves and the insurers they worked with without regard to their customers' interests. Two practices allegedly uncovered by the Spitzer probe were the abuse of contingency fees and bid rigging.

Contingency fees are set up under certain "placement service" or "market service" agreements, whereby an insurance company pays brokers a contingency fee (characterized by some as a kickback) in exchange for steering business to the company. These fees (or contingency commissions) are usually linked to the volume and profitability of the business directed to the insurer. Spitzer indicated that one insurance executive explained that the amount of the contingent commission would determine "who we are steering business to and who we are steering business from." In 2003 alone, Marsh & McLennan reportedly collected $800 million in contingent commissions.

Bid rigging occurs when brokers solicit fake bids from insurance companies. This allows the broker to submit one or more artificially high bids to the unsuspecting client with the intention of steering the client to choose a pre-selected insurer that appears to have a more reasonably priced bid.

So far, the victims of the alleged abuses appear primarily to be large corporations purchasing commercial property and casualty coverage. But some contend that the findings in the property and casualty industry are just the tip of the iceberg, and the numerous state regulatory investigations prompted by Spitzer's findings have extended to group health, life and disability, employee benefits, and personal insurance.

In an October 14 press release, Spitzer said, "The insurance industry needs to take a long, hard look at itself. If the practices identified in our suit are as widespread as they appear to be, then the industry's fundamental business model needs major corrective action and reform. There is simply no responsible argument for a system that rigs bids, stifles competition and cheats customers."

### A Stout Defense

The spotlight cast on the insurance industry by the Spitzer complaint comes as Congress is already focused on insurance regulatory reform,[2] and many have asked how the criminal activities alleged in Spitzer's lawsuit managed to escape detection. Four days after Spitzer's press release, a *Wall Street Journal* article questioned whether state regulators are up to the task of policing the insurance industry.

While some are calling for a federal regulator to replace the state regulatory system, supporters of the state-based system (including several witnesses at the November 16 hearing) defend the system on a number of fronts and caution that hasty reform in the face of a crisis can open the door to new and unforeseen problems.

Defenders of the insurance industry and/or the state regulatory system offer a number of responses to Spitzer's charges:

*The State System Is Working*: The push for a federal insurance regulator suggests that federal oversight, by its very nature, would be more effective. However, many claim that the evidence in the Spitzer investigation points to the effectiveness of the state regulatory system. The investigation was conducted by the state attorney general's office in conjunction with the New York Superintendent of Insurance. Allegations of wrongdoing were aggressively pursued by state authorities acting under state law, and the charges filed were based on state—not federal—laws.

*Greater Transparency Is the Cure*: While the practice of paying and collecting contingent commissions has been in place for decades—it is so well-established it even has a line item in the NAIC annual statement—Spitzer contends that these commissions should be eliminated altogether because they create an unacceptable conflict of interest that, like devil's candy, ultimately leads to illegal behavior based on irresistible temptation.

Spitzer's critics argue that the industry should not be condemned because of the misdeeds of a few bad apples. They point out that the irresistible temptation is not as widespread as Spitzer suggests because for most brokers, the differences between fees offered from one insurer to the next is not significant, and therefore the temptation to steer clients simply does not exist. These critics also argue that most insurance brokerages do not have sufficient market share to demand incentives from the insurance companies (Marsh and Aon Corporation, on the other hand, hold a combined 70 percent of the insurance brokerage market).

Those who do not want to see contingent commissions eliminated argue that increased transparency and disclosure are the keys to restoring true competition in the marketplace. In most states, the broker-client relationship does not create a fiduciary duty. And while most

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clients are aware and fully expect that commissions are paid, they often have no idea of the nature or full amount of the fees.

The common comparison made between brokerage commissions and real estate commissions is apt. Through disclosure requirements, home buyers know whom the realtor represents and that their realtor will make more money from a higher sale price. The competitive marketplace is maintained because homebuyers know the realtor's exact compensation structure and that no hidden incentives are directing the transaction.

*Don't Get Sidetracked*: For nearly four years, Congress has been studying the insurance industry with an eye toward increasing uniformity and efficiency of regulation. Along those lines, a consensus proposal for an optional federal charter has been floated by the American Bankers Insurance Association, the American Council of Life Insurers, and the American Insurance Association. In addition, Reps. Michael Oxley (R-Ohio) and Richard Baker (R-La.) of the House Financial Services Committee have circulated a draft bill known as the State Modernization and Regulatory Transparency (SMART) Act. Some argue that weaknesses in the current state insurance regulatory system exposed by Spitzer's investigation provide another reason for the industry and Congress to continue to focus on state-based reform efforts rather than become sidetracked by Spitzer's headlines.

*Crime Happens*: Supporters of the state regulatory system also point out that no amount of regulations—federal or state—can eliminate crime altogether. State regulators and the insurance industry universally condemn the criminal conduct uncovered by the Spitzer probe, but charging state regulators with failure to adequately perform their duties is "like saying the police failed when they make an arrest," according to New York Superintendent of Insurance Gregory Serio. State-based regulation remains important because, as in most areas of the law, state authorities are the front line in the war against fraud and abuse. Moreover, regulation at the local level provides accessibility to consumers and allows regulators to be more responsive.

## Immediate Repercussions

Spitzer's investigation and the charges levied as a result of it have produced widespread and immediate results throughout the insurance industry. Many states have launched investigations into the practices challenged in New York. A number of brokerage executives have lost their jobs or resigned (some having pled guilty to illegal conduct), and many brokerage companies have announced wholesale changes to their business practices, including the discontinuation of contingency arrangements with insurers.[3] It seems that whether or not firms believe contingent commissions create an actual conflict of interest, the mere appearance of a conflict now warrants an about-face on the longstanding practice of collecting those fees. Full disclosure is now the mantra.

On the regulatory front, it is unclear what direction the controversy will take. On December 7, 2004, Spitzer announced that he intends to run for governor of the state of New York. With his attention on the campaign, insurance industry stories may slip quietly off the front pages. On the other hand, Spitzer's office is broadening its investigation of the industry beyond compensation issues to include, most recently, the sale of questionable "insurance" products that lack the transfer-of-risk component associated with traditional insurance products.[4]

At this point, it's too soon to predict the final results of Spitzer's investigation and its many aftershocks. But with consumer confidence in jeopardy and the potential for revolutionary changes in the way insurance is conducted with customers, agents, and distributors, it is certain that the insurance industry will remain sharply focused on—and involved in—developments at both the state and national levels. ✮

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## End Notes

1. Witnesses at the hearing, entitled the "Oversight Hearing on Insurance Brokerage Practices, Including Potential Conflicts of Interest and the Adequacy of the Current Regulatory Framework," included representatives from the multi-faceted layers of the insurance industry. The first panel consisted of distinguished public servants currently serving their respective states: New York Attorney General Eliot Spitzer, Connecticut Attorney General Richard Blumenthal, California Insurance Commissioner John Garamendi, and New York Superintendent of Insurance Gregory Serio (who was also representing the National Association of Insurance Commissioners [NAIC] in his role as chair of the NAIC's Government Affairs Task Force). The second panel was made up of Albert Counselman, president and CEO of Riggs, Counselman, Michaels & Downes, Inc. (representing the Council of Insurance Agents and Brokers); Alex Soto, president of InSource, Inc. (representing the Independent Insurance Agents and Brokers of America); Ernst Csiszar, president and CEO of the Property Casualty Insurers Association of America; Janice Ochenkowski, vice president for external affairs for the Risk and Insurance Management Society; and J. Robert Hunter, director of insurance for the Consumer Federation of America.
2. The House Financial Services Committee has conducted 16 hearings on insurance reform since January 2001.
3. Likewise, several insurers have announced they will no longer pay contingent commissions.
4. The concern is that such products allow corporate purchasers to disguise what amounts to short-term loans and manipulate the bottom line on balance sheets and income statements.

# The New Regulatory Age

*Companies face a host of challenges in complying with increasingly aggressive and sometimes competing regulators.*

By William M. Goodyear

Like it or not, we are in a new "activist" regulatory age that has created new business challenges, and opportunities, for many companies. The impact of today's regulatory environment is seen daily in the headlines—and in the activities of the Securities and Exchange Commission (SEC), New York State Attorney General Eliot Spitzer, and many other "competing" regulators. Sarbanes-Oxley and "whistleblower" compliance issues, in combination with expansion of the regulatory oversight rules and other actions by bodies like the new Public Company Accounting Oversight Board, have contributed to an ever more challenging environment for corporate management teams to decipher.

New federal procurement regulations and other challenges to the energy, financial services, environmental, health-care, and securities industries continue to mount—examples include the Sarbanes-Oxley Act of 2002, the HIPAA Security Standards Final Rule of 2003, the Medicare Prescription Drug and Modernization Act of 2004, and the SEC Registration of Hedge Fund Investment Advisors. These and other new regulations have dominated headlines, and most companies have been directly or indirectly impacted. Further complicating matters, whistleblower regulations have required over 6,700 publicly listed companies in the United States to enact whistleblower procedures covering over 62 million employees, which will undoubtedly generate a myriad of issues that will have to be dealt with.

Additional evidence of the heightened regulatory environment in 2004 can be found in the creation of the previously mentioned Public Company Accounting Oversight Board—with a fiscal 2004 budget of more than $100 million and a targeted staff level of 284 people—as well as the expansion of the SEC, with a budget increase to $893 million, funding for 950 additional investigators, and recent hires earmarked for examination, enforcement, and market-regulation efforts. Never before have so many regulatory bodies and individuals had the potential to influence corporate behavior, policies, and business models.

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## Working toward Compliance

Entire industries, via "industry sweeps," are now subject to, and affected by, new regulations. The impact is being felt not just by the entities that break rules and create the need for heightened scrutiny and business accountability, but by all organizations. New policies and regulatory changes are having an impact on almost every industry, and brokers, property and casualty insurers, and life and health insurers are all experiencing the impact of regulatory investigations, lawsuits, and subpoenas. These parties are now working with outside counsel to review their internal practices—either as a response to emerging litigation or in an effort to understand potential exposure.

To work toward successful compliance, an organization's management team must ensure that policies are in place to deal with the most significant challenges, including:

**Discovery:** If a company has been named in litigation, it is imperative to preserve, manage, and produce all e-mail messages and other documents relevant to the matter. This can be a daunting challenge for many reasons—multiple platforms and computer systems are often used, and, for example, one policyholder can appear in several databases. Effective discovery plans and procedures are increasingly complicated.

**Contingent Fees:** The facts associated with contingent fee revenue—including potential lines impacted, offices engaged, and the years involved—are not easily identified. Other essential needs include the ability to perform forensic underwriting audits, fraud investigation, and damages quantification.

**Independent Oversight:** In any investigation, independent experts *must* be in place to fairly assess the current situation, the Board of Directors' and Audit Committee's responsibilities, and any additional steps that may be required. This work by the independent experts often includes reviewing all minutes of the Board and Audit Committee meetings, interviewing the Board members, and reviewing the findings of contingent fee investigations and outcome models.

**Internal Changes:** Significant changes in business operations are likely to develop as a result of these investigations. Many insurers may undertake an independent review of their risk management, internal control, and compliance infrastructure. Companies in all likelihood will need to enhance

### Opportunities in the Compliance Industry

On the flipside of the business challenges resulting from increased regulation are the business opportunities companies in the regulatory compliance industry have realized. For specialized consultants like Navigant Consulting, this has meant strong revenue growth; larger, longer-term mission-critical project engagements; and geographical expansion to ensure that national best practices teams of experts can meet clients' needs for deep industry expertise and experience in a timely manner.

This success does mean higher expectations and business challenges. For professional service companies, this means pressure to show timely results. Expectations now include:

- Ability to deliver results quickly
- Check-offs early and often on project assignments
- Elimination of open-ended engagements
- Demand for industry-specific, proven expertise
- Unquestioned independence

Experience and size now count in a major way. Just as companies must anticipate and meet regulatory compliance challenges, professional service firms must anticipate and meet their clients' growing needs. Those that do this best will have the most success in 2005 and beyond.

internal controls by performing risk management and compliance assessments to benchmark policies, procedures, and infrastructure against best practices standards.

### Dealing with Change

While the regulatory "dust" for the insurance and financial services industries and numerous other industries is far from settled, the impact of the new regulatory environment has already resulted in a number of critical lessons learned:

- Regulatory change is not new and can best be viewed as a constant in the business world.
- Management teams must now anticipate and quickly react to the changes that will be brought about by new rules and regulations.
- Regulatory change happens first—"marketplace interpretation" follows. The initial impact of regulatory change is expected to be straightforward, but the later interpretation of new regulations can have a dramatic impact on business, especially because the proper process needed to be "in compliance" is often open to debate.
- Control of the process is critical. As stated above, much of the impact of new regulations is based on interpretation. Waiting on others to provide the roadmap for compliance simply creates a more challenging future.
- Increased complexity and time urgency in regulations, combined with increased levels of complexity and cost, further add to the challenge. By acting proactively to ensure compliance and instituting preemptive reviews and electronic communication policies, management teams can be ahead of the curve and position themselves much more cost-effectively. Surviving in the new regulatory environment means dealing with these tough issues early to avoid fines, damaged reputations, serious impact on market capitalization, and (for some) potential criminal prosecution.
- Regulatory change can often be anticipated—in most situations, companies can predict what regulatory change is coming. Do not wait on the new rules to think about their impact on your organization. Anticipate, make the right decisions, and move forward to stay one step ahead of the changes.
- Prepare for industry-wide "sweeps," which often mean swift, comprehensive regulatory body reviews of internal and external business practices and policies for companies in a specific industry (e.g., mutual funds, insurance). Regulation today moves at a rapid pace, and the overall timeline of the traditional regulatory cycle has rapidly increased.

In addition to the factors mentioned above, other significant driving forces promise to continue to impact regulatory compliance issues. The loss of regulatory and public trust has been profound in many cases and is deepened every day as new allegations surface. Consumers are empowered as never before to express their dissatisfaction with companies, switch providers, campaign for new legislation, and file complaints with their regulators.

Finally, company politics and internal-control breakdowns have always played and will always play a major role in the effectiveness of organizations. The leadership of these organizations must work with their Boards of Directors and employees as never before to move companies forward and avoid the pitfalls that can lead to major damage. The trust of employees, investors, business partners, and clients is more important than ever, and the level of scrutiny rises each day.

Accept it now and be prepared—the new regulatory age is upon us. Numerous compliance challenges have already been made clear, and more will become clear in the next few years. Companies and management teams that are willing to dedicate the time and resources now to review the state of their organizations' compliance "fitness" and take necessary actions will likely be the ones that realize rewards—or, at the very least, avoid damaging penalties. ✯

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Brian Atchison yesterday reminded us that, "If you can't measure it, you don't understand it." Some of the objectives that will be pursued by the new accounting subgroup that former NOLHGA Chair Jim Mumford and MPC Chair Jack Falkenbach announced yesterday are aimed at providing our system with better ways to measure some of the attributes that we must be able to describe in order to defend this system. The establishment of baseline technology standards through the newly formed technology group will also help in that regard.

Critics of the state guaranty system decry a perceived lack of consistency in how coverage decisions are made across the system. The new Coverage/Claims Committee that will be chaired by John Colpean will aim to defuse that type of criticism, and the statutory reform subgroup that Jack Falkenbach will chair should help develop a more uniform set of key statutory provisions across the states.

To the extent that the industry and how it is regulated may raise issues of proper corporate governance and organizational best practices, the work that has been done to articulate and develop standards in those areas, by our Legal Committee and by individual member associations like the Colorado association, will again demonstrate that we are anticipating and addressing such issues before concerns about them are laid at our doorstep by outside parties.

I'm not going to be Pollyannaish about the challenges before us. As Joe Horvath and others have noted, the debate about insurance regulatory reform ultimately is not likely to turn on the guaranty system, and many of the major players in the debate will be much more interested in concerns of their own than in the future of state guaranty associations.

But for my money, the fact that we can't control everything is no reason not to try to control what we can, in order to protect and preserve this system. I believe that because this system protects insurance consumers better than any alternative system anyone has yet posited, we should defend it, and perhaps we *must* defend it if it is to survive. The best defense will require us to be able honestly to say that we have done everything within our power to make the system as strong and effective as it can be. We must show that we deserve respect because we have earned it. And I believe that the steps we are taking will allow us to do precisely that.

Again, thank you for all of the hard work that all of you have put into this system, and for the good work that we will do together in the coming years. ✯

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## NOLHGA Calendar of Events

### 2005

| Date | Event | Date | Event |
|---|---|---|---|
| **February 23–25** | **MPC Meeting**<br>**Tampa, Fla.** | **August 18–19** | **NOLHGA's Legal Seminar**<br>**Park City, Utah** |
| March 12–15 | NAIC Spring National Meeting<br>Salt Lake City, Utah | September 10–13 | NAIC Fall National Meeting<br>New Orleans, La. |
| **May 16–18** | **MPC Meeting**<br>**Austin, Tex.** | **October 24** | **MPC Meeting**<br>**Hilton Head, S.C.** |
| June 11–14 | NAIC Summer National Meeting<br>Boston, Mass. | **October 24–25** | **NOLHGA's 22nd Annual Meeting**<br>**Hilton Head, S.C.** |
| **August 16–17** | **MPC Meeting**<br>**Park City, Utah** | December 3–6 | NAIC Winter National Meeting<br>Chicago, Ill. |