NATIONAL CONFERENCE OF INSURANCE LEGISLATORS
FINANCIAL SERVICES & INVESTMENT PRODUCTS COMMITTEE
NEWPORT, RHODE ISLAND
JULY 7, 2005
DRAFT MINUTES

      The National Conference of Insurance Legislators (NCOIL) Financial Services & Investment Products Committee met at the Hotel Viking in Newport, Rhode Island, on Thursday, July 7, 2005, at 1:30 p.m.

      Rep. Joe Hune of Michigan, Chair of the Committee, presided.

     Other members of the Committee present were:

          Sen. Joe Crisco, CT

          Rep. Mark Young, VT

          Rep. Bill Brady, IL

          Rep. Terry Parke, IL

          Del. Harvey Morgan, VA

          Sen. William Larkin, Jr., NY

          Rep. George Keiser, ND

          Rep. Gabe Leland, MI

          Rep. Leslie Mortimer, MI

          Rep. Frank Wald, ND

          Rep. Geoff Smith, OH

Other legislators present were:

          Rep. Craig Eiland, TX

          Rep. Shirley Bowler, LA

          Assem. Nancy Calhoun, NY

          Assem. Ivan Lafayette, NY

Others present were:

          Susan Nolan, Nolan Associates, NCOIL Executive Director

          Paul Donohue, NCOIL Director of State-Federal Affairs

APPROVAL OF THE MINUTES

     Upon a motion duly made and seconded, the Committee voted unanimously to

approve the minutes of its March 4 meeting in Hilton Head Island, South Carolina.

UPDATE ON STATE/FEDERAL FINANCIAL SERVICES ACTIVITY

     Mr. Donohue reported that currently eight bills were pending in Congress that represented various approaches to Social Security reform.  He stated that House Republicans announced that they would be taking action in the coming weeks to push for a vote on Social Security reforms.  He opined that a large Social Security reform bill rumored to be introduced by Ways and Means Committee Chairman Bill Thomas might be the vehicle for that vote.  Mr. Donohue pointed out that the Democratic side of the aisle is still overwhelmingly opposed to Social Security bills currently before the House.

     Mr. Donohue reported that three bills are currently pending in the Senate.  He noted that the newest bill introduced does not include provisions for a separate personal retirement account.  He opined that this could be the first indication that Administration may be retreating from its position that any Social Security bill must include such an account.  He reported that Senate Democrats have called the bill “a smaller version of a bad idea.”  He said that Senate Republicans are in the process of drafting a bill they hope to put before the Senate in advance of the fall recess.  Mr. Donohue indicated Senate Finance Committee Chairman Charles Grassley is behind these new efforts.

     Mr. Donohue reported on a battle in the House that pits the banking industry against the real estate industry.  He said that the Community Choice in Real Estate Act (H.R.111/S.98) and the Fair Choice and Competition in Real Estate Act of 2005 (H. R, 2660) are competing bills that attempt to, respectively, disallow and allow the banking industry's entry into real estate brokerage and management.  He said critics argue that the Bank Holding Act of 1956 and the Gramm-Leach-Bliley Act forbid banks from engaging in services that are non-financial in nature.  He said proponents argue that real estate firms are already involved in quasi-banking activities and thus it is only fair to allow banks to be involved in real estate.  He reported that this represents the fifth consecutive year that legislation has been introduced permanently barring banks from engaging in real estate activities, but that so far no bill has passed the House.

FUNCTIONAL REGULATION:  THE EVOLUTION OF BANKING AND INSURANCE PRODUCT REGULATION SINCE GRAMM-LEACH-BLILEY

Raymond Spudeck of the Florida Department of Financial Services/Insurance Regulation said that, in accord with Gramm-Leach-Bliley, the role of regulation is not dictated by a company's organizational structure but by what has become known as “functional regulation.” Under that standard, insurance products are regulated by insurance regulators, securities are regulated by state and federal security regulators, and banking products are regulated by state and federal banking regulators, he said.  He said the ultimate regulator with responsibility for financial holding companies is the Federal Reserve that, in turn, uses the same tools and measures used by functional regulators.  He opined that there are fewer gray areas today then there may have been five or six years ago.  He attributed the elimination of gray areas to the great effort that has gone into creating effective lines of communication among the various regulators.  That cooperative effort is now occurring at the international level as well, he said.

    Mr. Spudeck pointed out that sectionalization seen on Web sites that offer different types of financial products results from rules created by functional regulation.  As a result of the newly created cooperative communication network, redirection of consumer inquires to the proper regulator occurs whenever consumers call the wrong regulator for their problem.  He concluded that functional regulation has been very effective in the present marketplace.

APPLICATION OF SARBANES-OXLEY TO PRIVATELY HELD COMPANIES

Douglas Stolte, Virginia Deputy Insurance Commissioner and chair of the NAIC/AICPA Working Group, addressed the Committee on the working group’s plan to apply portions of Sarbanes-Oxley (SOX) to nonpublic insurance companies.  He said that the working group started work on its proposals two years ago and released its discussion draft in April of 2004.  He indicated that throughout the process the working group solicited and accepted input from commissioners, industry, and other interested parties.  He said it was a myth that the working

group’s suggestions were going to be incorporated into the Model Audit Rule, causing automatic adoption by states without legislation.

     Mr. Stolte said ten states and the District of Columbia have adopted the Model Audit Rule by statute and 12 states have adopted certain components of the Model Audit Rule via Annual Statement Instructions.  Mr. Stolte said that the working group plans to encourage those 12 states to either seek legislation or promulgate a regulation in order to adopt the revisions.

     Mr. Stolte next discussed the working group's development of the Model Audit Rule revisions.  He recalled that the group started out by studying the Sarbanes-Oxley Act of 2002, Security Exchange Commission (SEC) releases, Public Company Accounting Oversight Board guidance, and other related regulations within the banking industry.  He said the principles outlined in three sections of Sarbanes-Oxley offered best practices the working group thought should apply to all insurers.  Mr. Stolte explained that from Title II the working group incorporated ideas of more frequent audit partner rotation, prohibited non-audit services, a cooling-off provision, and scaled-back sanctions for small companies.  He said that from Title III the Working Group extracted a rule specifying audit committee independence, a requirement for an ethics code disclosure, and an exemption for small companies.  From Title IV the working group borrowed a requirement that management have ownership and responsibility for internal controls, that management assess the effectiveness of those controls, and that a certified public accountant attest to management’s assessment, he said.

     Mr. Stolte said that the working group believed that insurance companies should be held to high governance standards.  He said that policyholders pay premiums to transfer the risk of losses.  He explained that policyholders do not believe they are assuming risk and expect that their claims will be paid.  The effectiveness of tools used by virtually all financial regulators is dependent on the quality of financial information being created and filed by the insurer, he said.

     Mr. Stolte said that regulators recognize the cost to the affected companies, which explains why the “small company” exemption and a prudent implementation period exists.  With that said, he stated that the working group was open to alternative suggestions.  The group’s new rules would result in a reduction in the number and magnitude of insolvencies, more efficient and effective risk-based financial examinations and audits, and a heightened awareness by ownership of the company’s internal controls, he said.  He pointed out that regulators of other financial services such as banks and securities have had similar provisions in place for a number of years.

     Mr. Stolte explained that A.M. BEST’s*Insolvency Study, Property/Casualty U.S. Insurers, 1969-2002*showed that with the possible exception of insolvency due to catastrophic losses, all primary causes of insolvencies were traceable to some form of mismanagement.  He predicted that heightened corporate governance and financial disclosure requirements resulting from the Sarbanes-Oxley Act would have positive implications for the financial strength of the industry in general.

     Mr. Stolte said guaranty funds are largely pass–along vehicles in that insurers are allowed to utilize guaranty fund assessments as a credit against premium taxes and/or as a cost in requests for rate increases.  Mr. Stolte added that assessments are also deductible for income tax purposes.  He warned that guaranty funds do not provide policyholders with a timely fail-safe protection against losses from insolvencies.  Many states impose certain dollar limits per claimant and may require some claimants to wait for future assessment before the funds become available, he said.

     In conclusion, Mr. Stolte stated that during his 22 years with the Virginia Department of Insurance, he had been involved in six insolvencies in which the common factors were a lack of internal controls over financial reporting, poor corporate governance, and a less than robust external audit process.  He asked legislators to give him the tools to be an effective and efficient solvency regulator.  He said he is committed to working with all sectors of industry to find a cost-effective method for regulators to receive positive assurances regarding internal controls over financial reporting.  He said the proposals of the working group are still a work in progress and that everything is on the table and up for discussion.

     Rep. Bowler questioned how the working group would define a “small company.  Mr. Stolte replied that the working group chose to define “small company” differently under each title.  Under Title II, a small company is defined as any company below $100 million in revenue; under Title III, any company below $200 million in revenue, and under Title IV, any company below $25 million in revenue, he said.

     Sen. Brady inquired if the working group had done any sort of cost-benefit analysis of its proposals.  Mr. Stolte replied that it had not done a cost analysis at this point because it had not come to any definitive decisions on the final makeup of the expensive Title IV requirements.  He added that industry had done its own analysis.  Sen. Brady expressed concern that the potential cost would be passed on to consumers by the insurance companies.  He recommended that the working group conduct a cost-benefit analysis.  Mr. Stolte stated that he was confident that the working group would do a cost-benefit analysis before it made final recommendations and that implementation of the working group’s recommendations would be contingent upon the benefits of the program outweighing the costs.

     In response to a question from Rep. Parke as to where the working group proposals would go after they were finished, Mr. Stolte replied that final recommendations would move from the NAIC/AICPA Working Group to the Financial Condition (E) Committee, then to the Executive Committee, and finally to the Plenary Committee.  Members at any of those levels may modify the proposal as they deem appropriate, said Mr. Stolte.  Rep. Parke requested that concerned legislators contact their NAIC commissioners.  Mr. Stolte indicated that would certainly be one way to accomplish that goal.

      In response to a question from Rep. Young concerning the “cooling-off” provision and its necessity, Mr. Stolte replied that the provision was developed to insure the independence in mind and spirit of the CPA.  The proposed provision would prevent the auditor from being lenient to a company in hopes of getting a lucrative job with the company post audit, he said.

     In response to a question from Sen. Hune regarding the percentage of insolvencies derived from mutual insurance companies, Mr. Stolte stated that NAMIC figures indicate that about five percent of insolvencies involve mutual insurance companies and that he believed that figure to be accurate.

     Neil Alldredge of the National Association of Mutual Insurance Companies (NAMIC) stated that his organization is not in favor of applying SOX-like standards to nonpublic companies.  He said that the high cost of compliance and the small percentage of mutual insurance companies that become insolvent were the main reasons for NAMIC’s opposition.  Since 1992, only five mutual insurance companies have become insolvent, he said.  A cost-benefit study commissioned by NAMIC, which applied all the governance provisions of Section 404 of SOX, revealed that the cost of the proposal would be eight times the benefit or about $300 million, he said.  He explained that there was no need for SOX standards for mutual companies because SOX was originally created to protect investors in public, not private, companies.  He pointed out that, despite assertions that the working group was taking suggestions from those outside the group, not one word of the Title IV proposal had changed since release of the working draft two years ago.  He concluded that while there is room for improved solvency regulation, the SOX proposal is not the solution.

      Bruce Ferguson of the American Council of Life Insurers (ACLI) stated that ACLI thought insurers should have good internal controls and be able to prove their effectiveness but that employing all the Section 404 governance provisions of SOX to non-public insurers is inappropriate, given the plethora of regulations to which insurers are already subject.  He recommended that any proposal be adopted through legislation and that a seasoning period be included to allow states to approve the proposal with a uniform effective date.  He reported that ACLI had submitted an alternative proposal to Mr. Stolte.

     Mr. Ferguson stated that ACLI's proposal was a risk-based approach towards identifying those types of processes that would require testing as to internal controls.  He said companies that are Securities and Exchange Commission registrants would be required to perform little additional work since they are already have those requirements under Sarbanes-Oxley.  He explained that a small-company exemption would be set at $500 million in annual and assumed premiums.  He further explained that under the proposal no external audit of internal controls would be required and that required internal audits would be done at the legal entity level rather than at the holding company level.

     Bob Zeman of Property Casualty Insurers Association of America (PCI) indicated that while the cost of SOX provisions has been abundantly discussed no explanation has been provided as to exactly how the working group’s proposals would fill any gaps that currently exist in state regulation.  He suggested examining how and why past insolvencies have occurred and then showing how the SOX provisions would have prevented those insolvencies.  He finally called for enhanced and extensive discussions between the working group and industry on the SOX proposal.

      Del. Morgan asked Mr. Stolte if ACLI's proposal was workable given the small-company exemption and the lack of external audit controls.  Mr. Stolte responded that under ACLI's proposal the internal auditor would be required to make available a “significant deficiency letter” that would provide positive confirmation of a problem.  Mr. Stolte also explained that small companies would still have to react although, at this point, no specifics existed as to the level of testing or documentation over internal controls that would be required.

     Sen. Larkin commented that the working group was going to have to be more precise in the proposal’s language, specifically, those areas that address how a small company and independent auditor are defined.

     Ed Stevenson of Barnert and Associates, representing The National Alliance of Life Companies (NALC), stated that the question was not whether insurers have internal controls but to what extent they are formalized.  Companies with more than one layer of management need more formalized internal control processes to ensure the effectiveness of their internal audit processes, he said.  He explained that smaller companies with only one layer of management, where direct supervision of internal processes is frequently possible, need fewer formalized internal controls.  He said regulators have much less to look at when attempting to assess the internal controls of such companies.  He concluded that Congress has already drawn the line by requiring public companies to comply with Sarbanes-Oxley.  He continued that non-SEC registrants tend to be smaller and less complex and therefore a formalized internal controls process is a much less efficient choice for these entities.

     Rep. Hune asked all those that testified if they would be willing to work with the Committee to find an alternative.  All agreed, but Mr. Aldridge qualified his agreement by saying he would only agree if the work was directed towards solvency reform, not investor-oriented policy reform.

[PAYDAY LENDING MODEL ACT](http://www.ncoil.org/Private/2005/PaydayLendingModelA.pdf)

     John Rabenold of Check N’ Go and Mike Waters of Payday Loans addressed the Committee on the area of payday lending legislation both individually and in their capacity as members of Community Financial Services Association of America (CFSA).  Mr. Rabenold said that the CFSA had worked with the American Legislative Exchange Council (ALEC) in drafting a *Model Deferred Presentment Services Act*, which Rep. Hune had submitted to the Committee.

     Mr. Rabenold said that currently 38 states had passed legislation or revised existing legislation to make payday lending available to consumers.  He said that consumers need an alternative to traditional forms of short-term lending and that payday loans fill that need.  He explained that two-thirds of those accessing payday lending use it for emergencies and approximately one-third use it as discretionary income.  He argued that the cost of payday loans was lower than the cost of a bounced check, which in some states can be upwards of $60.

     Rep. Parke pointed out that Illinois passed payday lending legislation this year and it had near unanimous support from both consumer groups and industry.  He said that payday lending establishments were important facilities in neighborhoods.  He explained that there was a great call for payday lending because the need was not being met by other institutions.

     Rep. Robertson asked how many states have payday lending legislation that specifies a declining fee schedule, like Michigan's legislation.  Mr. Rabenold replied that approximately eight states have similar legislation in which the larger the loan amounts, the smaller the fee permitted.

      Del. Morgan stated that while there is a need for payday lending, he had concerns over legislation that allows loans to grow and grow.  He expressed the hope that any model legislation would provide for the use of a central database, such as in legislation passed in Florida and Oklahoma.  Mr. Rabenold replied that while his group worked with many different databases, it supported the use of the private database, which he claimed provides more information.

     Rep. Kaiser concurred with the need for a public database, but emphasized that any payday lending model legislation needed to address electronic transfers.  He claimed that in very short order, the majority of payday loans in the country would be made electronically with offshore entities.

     Rep. Hune requested that interested parties submit comments on this legislation by September 7, 2005.

ADJOURNMENT

     There being no further business, the meeting adjourned at 3:45 p.m.

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