CPCU SOCIETY INSURING YOUR SUCCESS 1944-2004 Celebrating the Past, Shaping the Future

Regulatory & Legislative Quarterly

RLQ

Volume 12 Number 1 March 2004

Spotlight on the Co-Chairman/Editor

Eric C. Nordman, CPCU, CIE, is director of research with the National Association of Insurance Commissioners.

Eric C. Nordman, CPCU, CIE, is currently serving the needs of the state insurance regulatory community in his capacity as director of research with the National Association of Insurance Commissioners (NAIC). He supervises the Research Division staff in a wide range of insurance research, supporting NAIC committees, task forces and working groups, and operating an insurance research library. He previously held the position of NAIC senior regulatory specialist with the NAIC prior to his appointment as director of research in 1997.

In his position, Nordman supports a number of NAIC committees, task forces, and working groups on various topics, including the Property and Casualty Insurance Committee, the Casualty Actuarial (C) Task Force, the Market Conditions (C) Working Group, The Terrorism Insurance Implementation (EX) Working Group, the CARFRA Working Group, the Crop Insurance Working Group, the Functional Regulation (EX) Working Group, the Class Action Insurance Litigation (C) Working Group and the Catastrophe Insurance (C) Working Group. He provides expertise on loss costs, auto insurance, crop insurance, catastrophe issues, property insurance, workers compensation, electronic commerce, speed to market issues, terrorism reinsurance issues, medical malpractice issues, and other property and casualty issues. Most recently, specifically in the aftermath of the events of September 11, 2001, he has been involved in the discussion and resolution regarding coverage issues related to acts of terrorism. He responds to questions by the various state insurance regulators and provides advice on various matters relating to property and casualty insurance, and filing of rates and forms by insurers in the states.

Nordman was previously employed by the Michigan Insurance Bureau for 13 years. Positions held for the Michigan Insurance Bureau included auto analyst, workers compensation analyst, director of the property and casualty section that regulated rates and forms submissions, and deputy director of the commercial market standards division.

He received his bachelor's degree in mathematics from Michigan State University. The Insurance Regulatory Examiners Society has granted Nordman its highest designation, that of Certified Insurance Examiner. Nordman also has served on the National Advisory Committee for the Robert Wood Johnson Foundation's Workers Compensation Health Initiative and was a member of the National Insurance Task Force of the Neighborhood Reinvestment Corporation. He is co-chairman and newsletter editor of the CPCU Society's Regulatory & Legislative Section and serves on the Workers Compensation Steering Committee of the National Academy of Social Insurance.

A Note from the Editor

Sorry this issue has been so long in coming. Our goal for 2004 is the publication of four newsletters. This is the first in the series.

The section is planning to co-host an educational event during the NAIC's 2004 Spring National Meeting in New York. The session will deal with class-action litigation and its impact on insurers and insurance regulators. District of Columbia Commissioner Larry Mirel will serve as keynote speaker. A panel will follow his address with a claims person, a consumer advocate, and Donald Beatty, general counsel from the Virginia Bureau of Insurance. Watch for details in the NAIC's meeting program. The session will take place on Saturday, March 13, 2004, from 9 to 11 a.m.

The next newsletter will feature an article titled "1944." It will take a retrospective look at the issues that were facing the insurance industry and insurance regulators when the CPCU Society was in its infancy. You will be surprised at the many parallels that have been identified.

And finally, a reminder to those who have not taken advantage of a significant benefit of membership in the Regulatory & Legislative Section. During each NAIC meeting, several meeting dailies are produced that briefly summarize important meetings and regulatory issues of the day. If you are not receiving these important and informative communications, you are urged to send an e-mail message to Pam Simpson at the NAIC and ask to be added to the distribution list. She can be reached at psimpson@naic.org.

Enjoy this issue. As always, your comments and suggestions are welcome. Feel free to grab a pen . . . or personal computer . . . and drop me a line. I can be reached at enordman@naic.org. ■

More Than a Crystal Ball

by Damian V. Sepanik, J.D., CPCU

Damian V. Sepanik, J.D., CPCU, is an attorney in private practice concentrating on insurance regulatory matters. During his tenure as an insurance company executive, he served as general counsel for several business units and headed an internal coverage litigation law firm. Sepanik also serves as co-chairman of the CPCU Society's Regulatory & Legislative Section.

Editor's Note: Damian Sepanik recently spoke before the Defense Research Institute (DRI). The topic was "More Than a Crystal Ball: Looking at What's on the Horizon." Excerpts from that speech follow.

We finally have a hard insurance market. What impact is that going to have on the kind of insurance coverage claims and disputes that lawyers are going to see and the way that insurers respond to them?

I think that in order to understand the impact, it is important to understand what the insurance industry is faced with.

There are many who track our industry that are saying that the current hard market is much more than just a market cycle issue. There are fundamental changes taking place in the industry that are necessary for its survival.

First, let's start with my admittedly overly simplistic view of insurance finance. Insurance companies make money by taking in cash in the form of insurance premiums. Actuaries base those premiums on an assumption of adherence to underwriting guidelines and the law of large numbers. The idea is to charge enough in premiums to allow you to pay claims and expenses at a later date and still have enough left to put in your pocket. The timing aspect here is important. Insurance companies collect money now for payout later. That means that they can benefit from investing the premiums. If the actuaries get it right and the company takes in exactly what it takes to pay claims and expenses, also known as a 100 percent combined ratio, the cost of the invested funds is zero. Warren Buffet calls this the cost of float. The insurance company keeps the investment gains and life is good.

The price tag of the U.S. tort system has continued to escalate from $129 billion in 1990 to $179 billion in 2000 to an estimated $298 billion in 2005.

When returns on the float are exceedingly good, companies with sloppy underwriting practices get away with it. They can have combined ratios above 100 percent because, while the cost of float is higher, their returns are as well.

This is what happened to a lot of companies in the late 1980s and the 1990s. Companies viewed cash flow as king and rewarded underwriters for putting business on the book. The focus was on top line growth. Excess losses were funded by ever-rising returns on the float.

Then the stock market bubble burst and the tragic events of 9/11 occurred. For the first time ever, the insurance industry posted a net loss of $7 billion.

This was a wake-up call in many ways. Average combined ratios were 116 percent in 2001. The strain on capital was severe. Companies declared themselves insolvent or rating agency downgrades forced them into that position. Rating agencies and regulators became very active and very conservative.

And this is where we come in. Companies reacted by refocusing efforts on quality underwriting. At the same time, many went on painful expense reduction diets. By 2002, the property and casualty combined ratio was settling into the 106 percent range, but the rating agencies and, in fact, most CEOs were not satisfied. The reason is that along with the fact that investment returns are returning to more traditional levels, the industry is facing a host of challenges that have proven difficult to measure or predict.

The price tag of the U.S. tort system has continued to escalate from $129 billion in 1990 to $179 billion in 2000 to an estimated $298 billion in 2005. New and creative tort exposures seem to crop up on a regular basis. There is no end in sight to asbestos losses (the gift that keeps on giving). The ability to predict loss has become more and more difficult.

Having said all of this, I think many companies are in the position of having cut out as much expense fat as possible and taking all the steps they could to make themselves better underwriters. They are getting as much in premiums as the market can bear and they are running as lean as possible. The only area left is to make sure that as few dollars go out the back door as possible. This is the new era of claims.

I think you will see a renewed emphasis on creating a knowledgeable and efficient claim organization. One that recognizes the claims that should be paid quickly and the claims that should be litigated. One that recognizes the claim organization as a source of knowledge for the underwriting function. I think companies will be willing to invest money to achieve high levels of quality, but will be much more focused on results and intolerant of failure. CEOs are also demanding that they not be

surprised by claims blowing through reserves. With the rating agencies, Wall Street analysts, and insurance regulators breathing down their necks every time quarterly statements come out, companies cannot afford any adverse blips. This will require more communication between attorneys and their clients at perhaps a much more detailed level than in the past. Finally, I think the more professional, efficient, and expense-conscious claim organization is going to look to counsel more and more to help create litigation budgets to avoid surprises on the expense side of the equation.

What are the new claims and coverage issues that you see emerging?
I think that you will see the following new claims and coverage issues arising:

- the impact of the U.S. Supreme Court decision in *State Farm v Campbell* limiting the awards of punitive damages
- additional insured issues and the underwriting response to those issues
- the continuing importance of successor liability and missing policy issues, particularly in the context of long-tail claims (i.e. asbestos)
- insurance coverage for elder abuse claims
- mold claims, particularly use and exclusion of expert testimony and causation
- allocation, particularly in construction defect and asbestos cases
- Congressional asbestos reform
- asbestos-caused bankruptcy

Some insurers have created their own internal law firms to handle insurance coverage issues. What kind of strategic considerations do you see major property and casualty insurers using in deciding how to apply legal resources to coverage issues and, in particular, what kind of balance do you hope to see between using traditional panel counsel and in-house resources?
I think insurers have been guilty of misusing their attorneys both inside as well as outside. All too often the same questions are being asked over and over, oftentimes resulting in different answers being provided. Smart companies will begin to organize in ways that allow them to work smarter.

I would break the considerations down to three broad categories: efficiency, consistency, and knowledge.

Efficiency

Companies will have fewer resources that are asked to do more than ever. The one-stop-shopping approach of having in-house counsel is a godsend to a busy claim professional who may not be fully equipped to make an appropriate legal resource purchase decision. In-house counsel have tremendous knowledge of the culture, the personnel, and the changes occurring within the organization. Their ability to be proactive is heightened. They know who needs to be advised at what time. They are in a position to view things from an organizational perspective, not just an individual business perspective. They are also in a position to view the work of many outside firms and get a good idea of how consistent the quality really is. Finally, if managed correctly, in-house counsel can cost less.

Consistency

I can't imagine a lawyer being in a worse position than arguing a position persuasively and passionately, only to be confronted with written testimony from the client in another matter taking exactly the opposite position and not knowing about it in advance. Yet, multi-line companies can find themselves in this situation all too often unless they find a way to coordinate their efforts and share this information. In-house operations tend to be quite good at this function.

Knowledge

In-house organizations tend to know the industry, company, and products very well. They tend to understand the ramifications of certain business decisions very well, especially in light of the companies' ever-changing challenges. To the degree they are consulted during the drafting process, they develop first-hand knowledge of intent. They often know the demeanor of witnesses quite well because of prior dealings.

Outside Firms

Outside law firms bring three important benefits to corporations. First, they often offer what I like to call "the best in class." These are those attorneys that are recognized as being the best and the

Continued on page 4

More Than a Crystal Ball

Continued from page 3

brightest in a certain discipline, being that subject matter knowledge or litigation skill. In-house counsel may have that knowledge or skill, but the perception both within the organization as well as publicly, may be that the outside attorney is superior.

Second, they often have resources to throw at a project that the in-house attorneys just don't have. Yes, there is a perception that outside firms have legions of associates, paralegals, and clerks to throw at a project willing to work nonstop around the clock to ensure that it gets done on time.

> *The hard market will continue to take its toll. I think you will see more companies in financial distress. Reinsurers will act differently than they have in the past.*

Third, outside firms offer a certain level of objectivity. In-house counsel run the risk of relating too closely to a case. In addition, outside counsel, representing other companies, may have observed certain best practices, or for that matter, mistakes, of other companies and can use that knowledge to advise the company.

Balance

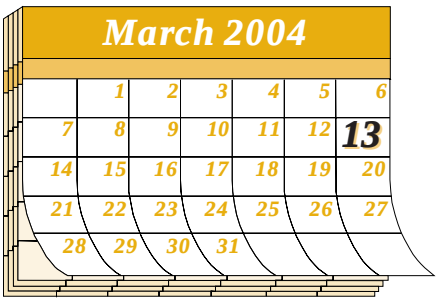
I think the smart claim organization finds a way to capitalize on all of these strengths. Clear understanding of what type of cases stay in house and those that are assigned to outside counsel is critical. Using in-house counsel as the control tower, monitoring cost, consistency, and quality is an effective model. Outside counsel that is very knowledgeable about a claim philosophy, the role of in-house counsel in that particular organization, and the company culture can be a very effective partner in achieving corporate goals. Finally, the ability of outside counsel to be a "knowledge asset" is a best-in-class attribute. The firm that can find a way to drive the knowledge it gains in providing legal services to the company is not only providing an immeasurable service, but is also setting itself up for a long-term relationship with the company.

What are the biggest changes that you foresee impacting insurance companies and their lawyers in 2004?
The increasing power of rating agencies. It will bring the need to predict and deliver on promises to a level of extreme importance. Examples of this include not just reserving and expense issues, but also case-law developments and, in particular, appellate cases. For example, Indiana recently issued a ruling regarding the absolute pollution exclusion with negative implications to the insurance industry. Many lawyers predicted a bad outcome. Were underwriters warned about this potential? Were they given a chance to price appropriately or, if appropriate, put a withdrawal plan in place?

The hard market will continue to take its toll. I think you will see more companies in financial distress. Reinsurers will act differently than they have in the past. This "gentleman's" business done on a handshake will see more contractual disputes and litigation. The uncertainty of reinsurance collection will put even more pressure on the primary carriers to produce good underwriting results.

The hard market will also continue to fuel the growth of the self-insured captive industry. This will be a good test of the regulatory oversight of these risk transfer mechanisms and we may see increased litigation in this arena.

Finally, the feds continue to get more and more involved in our industry. If the NAIC can't get its uniformity and other initiatives completed, the feds may want to get even more involved. If there is a major financial debacle, watch for a bigger oversight roll on the financial side of regulation. There is still hope that the feds may take a roll in addressing the asbestos issue. ■



Be sure to attend the Regulatory & Legislative Section's Educational Event

"Class-Action Litigation: Its Impact on Insurers and Regulators."

Join us on Saturday, March 13, 2004, at the Sheraton New York Hotel and Towers from 9 to 11 a.m. and stay informed on this important insurance and regulatory issue.

For more information contact Eric C. Nordman, CPCU, CIE, at enordman@naic.org.

Did you know . . .

Based on 2002 NAIC figures, the property and casualty industry has invested 55.9 percent of its assets in bonds and only 14.9 percent of its assets in equities?

Check out the Regulatory & Legislative Section web site at **http://rl.cpcusociety.org** for "Issues of the Day" postings. The current "issue" is *Asbestos Reform.*

And don't forget that you can sign up for NAIC meeting dailies via e-mail!

http://rl.cpcusociety.org

Regulatory and Legislative Update

Effect of Sarbanes-Oxley

On June 21, 2003, the NAIC's Risk Assessment Working Group and the CPCU Society's Regulatory & Legislative Section held an educational event to discuss corporate governance issues and the effect of Sarbanes-Oxley on the insurance industry.

Approximately 25 people attended. An informative panel discussion was led by former Pennsylvania Insurance Commissioner Linda Kaiser, now with Saul Ewing, L.L.P; Tom Mulhare, CPA (Amper, Politzner & Mattia); Mary Daniels, ARM (American Agency System), and James Becker (Saul Ewing, L.L.P.) participated on the panel.

The role of the auditor was discussed. The auditor is asked to review the information that is prepared by management. Material differences must be identified. One of the principle differences under Sarbanes-Oxley is that auditors are now subject to regulation by a federal board. Sarbanes-Oxley defines the role of internal auditors and external auditors. A clear separation of these rules must exist. It also requires a rotation of external auditors to maintain independence. There is also a one-year waiting period before an auditor can accept a management position with a firm that the person has audited.

Management must make a filing with the SEC to certify that the internal controls are adequate. The auditor must attest to the management certification.

The biggest area of change will be in regards to fraud. Auditors must question upper management concerning knowledge of fraud or the potential risk of fraud. Further, the role of whistleblowers has been elevated.

The role of the risk manager has evolved under Sarbanes-Oxley. This risk manager has become more important in enterprise risk management. The risk manager is asked to keep the company from losing money. Increased scrutiny of those serving on the company Board of Directors is required, and it is often the risk manager that is asked to perform the due diligence.

The impact of Sarbanes-Oxley on privately held firms will be noticed as audit firms will now set up two separate sets of auditing standards—one for public companies and one for privately held companies.

The federal government will actively prosecute any auditor or individual involved in fraud or failure to make complete and full disclosure of material financial results.

Internal entities and their auditors have expressed concern about the impact of Sarbanes-Oxley on them when they do business in the United States. These entities are subject to Sarbanes-Oxley and the SEC regulation on their U.S. business.

The panel involved the audience in an engaging dialogue to help all attendees better understand corporate governance issues and the impact of Sarbanes-Oxley on their daily lives.

■ *The federal government will actively prosecute any auditor or individual involved in fraud or failure to make complete and full disclosure of material financial results.*

TRIA Update

On November 25, 2003, the Treasury Department announced a proposed regulation under the Terrorism Risk Insurance Act of 2002 (TRIA), which was signed into law by President George W. Bush on November 26, 2002, in a White House ceremony attended by Commissioner Therese M. Vaughan, Ph.D., CPCU. November 26, 2003, was the first anniversary of TRIA and much has occurred during the last year to make its implementation a success. Led by Commissioner Vaughan (IA) and Gary Steuck (SD) with substantial help and support from Joe DeMauro (NY) and other members of the Terrorism Insurance Implementation Working Group, the NAIC's presence has not gone unnoticed on Capitol Hill.

The recently released regulation contains procedures for insurers to follow in filing claims for payment of the federal share of compensation for insured losses under the Terrorism Risk Insurance Program. It is the latest in a series of regulations that the Treasury has issued throughout the year to implement this program. Insurers and other interested parties had the opportunity to submit formal comments on the regulation, and the comment period will last for 30 days from the date of the regulation's publication in the Federal Register. The NAIC, through the diligent efforts of the working group and its staff support, has already provided its suggestions to Treasury. The NAIC has been influential in the drafting of each of the several published Treasury regulations through its close working relationship with the Treasury and its staff. Informal early drafts are shared with the working group, and regulatory input is sought before TRIA regulations are published. This partnership between the state regulators and the Treasury has proved valuable to both parties. TRIA contained several provisions that required the Treasury to consult with state regulators before taking certain actions.

Continued on page 6

Regulatory and Legislative Update

Continued from page 5

"The Terrorism Risk Insurance Program plays an important role in strengthening the nation's economy against the effects of international terrorism," said Treasury Assistant Secretary for Financial Institutions Wayne Abernathy, who oversees the program. "This temporary backstop for insurers promotes the availability of terrorism risk insurance coverage and encourages the development by the private sector of increasingly available resources for this protection."

Previously issued regulations laid the groundwork for the program, clarified the program scope, and implemented disclosure requirements of the Act. This proposed rule lays out the requirements and conditions insurers must meet in order to file for federal payment for covered losses. It clarifies elements of insured losses that are to be reimbursed under the program, and establishes fundamental documentation and record keeping necessary for insurers to receive the federal share of compensation for terrorism losses.

"The Treasury seeks to establish operational procedures that suitably emulate the best practices of the reinsurance industry," added Jeffrey S. Bragg, executive director of the Terrorism Risk Insurance Program. "Our goal is to respond quickly to insurer claims for payment while maintaining appropriate financial controls over the use of taxpayer funds."

The Terrorism Risk Insurance Program is a temporary federal reinsurance program designed to encourage the development of private sector resources and arrangements for managing risk of loss due to acts of international terrorism. The authority for the program expires on December 31, 2005. Regulations and other information related to the Terrorism Risk Insurance Program can be found at http://www.treasury.gov/trip/. ■

The Use of Insurance-Based Credit Scores and FCRA Reauthorization

On November 22, 2003, the Senate approved by unanimous consent legislation to renew the Fair Credit Reporting Act (FCRA). The House approved the measure on Friday, November 21, by a vote of 379 to 49. Reauthorizing the law, which expires at year's end, was a congressional priority.

The new act protects state insurance credit scoring laws, includes state insurance regulators as participants for a insurance credit scoring study, and gives consumers new protections against identity theft, including free credit reports annually and a national fraud alert system to minimize damage once a theft has occurred.

The bipartisan conference report establishes stronger federal protections against identity theft. It also overrides the new California privacy law—widely considered to be the nation's strictest financial privacy statute—by permanently extending expiring FCRA provisions that preempt state consumer protection laws. The conference report accompanying the legislation also provides for a study on the effects of credit scoring and credit-based insurance scores on the availability and affordability of financial products. Senate bill sponsors, backed by the financial services industry, said a permanent state law pre-emption would help provide a "uniform national standard" for consumer protections. But many Democrats, backed by consumer groups, argued that states should have the right to enact stronger consumer protections than those provided under federal law.

State insurance credit-scoring laws were protected from the federal preemptions. The "Disclosure of Credit Scores Section" of the act states that the reauthorization of FCRA "shall not be construed as limiting, annulling, affecting, or superseding any provision of the laws of any State regulating the use in an insurance activity, or regulating disclosures concerning such use, of a credit-based insurance score of a consumer by any person engaged in the business of insurance."

The study of credit scores and insurance credit scores is to be completed by the Federal Trade Commission (FTC) in conjunction with the Office of Federal Housing Enterprise Oversight (OFHEO). The FTC and OFHEO must "seek" public participation "about the prescribed methodology and research design of the study . . . from relevant Federal regulators, State insurance regulators, community, civil rights, consumer, and housing groups." Under the legislation, the study will be completed by November 22, 2005.

In another development, in January 2004, the state of Missouri released its report on the use of insurance-based credit scores and its impact on minority and low income populations in Missouri. The report is available on the state's web site. The report has led to an announcement by Missouri Governor Bob Holden that he would seek legislation to ban the use of credit for insurance purposes. ■

New Look for Newsletter

This issue premieres a new look for your section newsletter. This modern, dynamic design maximizes the space on each page while preserving an easy-to-read format. And keeping in line with our concern for the environment, the newsletter is printed on recycled paper.

Who's Managing *Your* Success?

CPCU Society National Leadership Institute

Invest in Your Professional Development—and Take Charge of Your Career Success!

Spring 2004 CPCU Society
National Leadership Institute
April 22-23, 2004 ◆ Tampa, FL

- Develop effective leadership, communication, and management skills to guide your company—and your career—to success.
- Gain real-world knowledge about managing and leading in the P/C industry.
- Prove that you have the drive and the know-how to get ahead in today's competitive marketplace.

Set Your Schedule for Success!

Thursday, April 22

8 – 11:30 a.m.

- Developing Resilience in a Rapidly Changing World

8 a.m. – 4 p.m.

- Effective Communication Skills
- Practical Techniques for Project Management
- Finance for Nonfinancial Managers
- Facilitative Leadership Skills
- Power Tools for Successful Negotiations

Noon – 1 p.m.

- Thursday Leadership Luncheon

1 – 4 p.m.

- Delivering Compelling Messages to Your Staff

1 – 4:30 p.m.

- Time Management—Managing the Only Non-Renewable Resource

5 – 6 p.m.

- Reception

Friday, April 23

8 – 11:30 a.m.

- Developing Resilience in a Rapidly Changing World
- Time Management—Managing the Only Non-Renewable Resource

8 a.m. – 4 p.m.

- Effective Communication Skills
- Practical Techniques for Project Management
- Finance for Nonfinancial Managers
- Facilitative Leadership Skills
- Managing Conflict in the Workplace

Noon – 1 p.m.

- Friday Leadership Luncheon

1 – 4 p.m.

- Becoming a Successful Leader

Register Today to Take Your Career to the Next Level!

Complete the registration form in your February/March issue of *CPCU News* and mail or fax it to the CPCU Society by April 9, 2004. Members can also register online at **www.cpcusociety.org**.

For more information, please contact the Member Resource Center at (800) 932-CPCU, option 4, or at **membercenter@cpcusociety.org**.

Commercial Lines Deregulation Revisited

by Justin L. Brady, CPCU

Justin L. Brady, CPCU, is a member of the CPCU Society's Regulatory & Legislative Section, and is involved with government relations work as an officer for an international insurer. He has been in the insurance business for 35 years, has coauthored and contributed to textbooks on insurance regulation, developed test questions and answers for an IIA course, and served on the Board of Directors of a CPCU Society chapter. He is married with two children and is a resident of Massachusetts.

In February 1997, this author wrote about the topic of the deregulation of various aspects of the commercial insurance business. At that time, the issue being studied by regulators was whether the insurance being purchased for many, if not most, commercial and industrial entities needed to be regulated. Two points made in favor of deregulation were that the buyers were sophisticated enough about insurance buying or they had access to such knowledge through the use of professional insurance brokers. Another point was that insurance regulation in this nation varied by jurisdiction unlike in other countries, thereby making it a lengthy and cumbersome process for a U.S. insurer to obtain approval for coverage and rating changes nationwide.

And that situation has placed such insurers at a competitive disadvantage compared to unregulated off-shore entities offering insurance products. Additionally, surplus lines insurers, purchasing groups, self-retention arrangements, captives, and risk-retention groups are increasingly being used by large commercial and industrial organizations that need special insurance arrangements but cannot wait for primary insurance carriers to receive product or rating approval from state regulators. Time is money for business, and time lost is money wasted. Months of review by state insurance departments of proposed commercial coverage and rating changes is not uncommon. Even if there were quick approval by say, 90 percent of the U.S. jurisdictions for a new or revised policy or endorsement, the remaining 10 percent are holding the product hostage. Fortune 500 entities with thousands of locations nationwide are not interested in being told by their insurers that depending where the loss occurs the coverage would vary, because not all the regulators have approved the form. It's an inappropriate way to have to conduct business, and policyholders (especially multinational corporations) do not understand it or desire it. Regulating just for the sake of regulating does not benefit either the insured or the insurer.

Recognizing that situation, some states have adopted the viewpoint that scarce regulatory resources are better used to oversee personal lines products that affect everyone rather than those offered to businesses that are able to fend for themselves in the marketplace. Unlike personal lines policies, the contracts offered to large commercial clients by their insurance companies are not contracts of adhesion. Even standardized policies used in this arena reflect provisions that are unique to large commercial interests.

Now commercial insurance deregulation will be revisited, as there is renewed interest by Congress in reviewing the concept of state regulation of the insurance industry, and some people are calling for federal rather than state oversight of this ancient and essential business. (Insurance of one kind or another has been in existence for centuries.) The General Accounting Office in September 2003 released a report to Congress on some aspects of insurance regulation; state insurance regulators have recently testified before Congressional subcommittees on the subject of state control of the insurance business, and insurance industry trade associations and some large insurance companies also spoke. However, the insurance industry is not unified in its view of state versus federal control, which can impact how Congress deals with the situation. In the past, Congress has generally not moved forward to make a fundamental change in the way a particular facet of commerce is governed unless there was some type of consensus among those involved in the transactions.

Some insurers prefer having to wait for an approval from a state regulator before they implement a change. A level of comfort (legal and otherwise) is provided by having an approval letter on record. Other carriers are not satisfied with state insurance regulation but do not see federal control as the solution to the problem. They cite the results of having federal involvement with crime and flood insurance as examples of their reluctance to have other insurance intervention by the United States government. Also, they express a fear of social engineering being done through the insurance mechanism if the federal government were to regulate insurance. Concern about dual regulation has also been expressed by some participants in the discussion. For example, one Congressional proposal involves the federal government regulating some parts of the insurance industry with the state governments regulating the other parts.

The National Association of Insurance Commissioners (NAIC) in 2003 adopted a new regulatory modernization plan entitled A Reinforced Commitment: Insurance Regulatory Modernization Action Plan. The NAIC views it as being a plan through 2008 for the streamlining of important parts of insurance regulation, including consumer protection, solvency regulation, market regulation, speed to market issues, and producer licensing. Whether the plan will be akin to rearranging the deck chairs on the Titanic remains to be seen.

Although there has been some progress made toward commercial insurance deregulation, the playing field is not yet level. It still depends upon where the insurance contract is written, with some states continuing to closely regulate the issuance of insurance policies, their content, and prices just as it has been done for more than 100 years. In contrast, there are states using much less regulation, with certain aspects of the insurance process having been deregulated for decades without market disruption occurring in those places.

Theoretically, insurance regulation is one of balance between the interests of insureds and insurers. A regulator is concerned about the solvency of insurers and their ability to conduct business, while simultaneously seeking to ensure that customers are not being taken advantage of in their dealings with insurers. Connecticut's General Statute Annotated 38a-8 for example says that:

> (a) The commissioner shall see that all laws respecting insurance companies and health care centers are faithfully executed and shall administer and enforce the provisions of this title. The commissioner has all powers specifically granted, and all further powers that are reasonable and necessary to enable the commissioner to protect the public interest in accordance with the duties imposed by this title.

With the statutes giving regulatory authority to state insurance commissioners, the Connecticut law is typical in its broadness. It enables the commissioner to adapt to changing conditions without having to request new or revised laws from the legislature. Having such broad authority also enables a commissioner to be liberal or conservative in the application of the insurance laws, or to be somewhere in between on the continuum of regulation. Regulatory philosophy can be derived from:

- the fact that the commissioner is appointed or elected
- the relationship the commissioner has with other elected and appointed officials
- the social, political, and economic conditions in a state
- the regulator's opinion about the scope of the position's authority
- that government official's personal beliefs
- the status of the insurance business in the state

> *. . . legislative action by states on making policy cancellation and nonrenewal requirements uniform among the states has been nonexistent.*

Reality is that some U.S. jurisdictions regulate insurance less or differently than others. Beauty is in the eyes of the beholder as to what's desirable for regulation. For example, state legislatures have come to realize that policy countersignature laws are no longer needed for an effective insurance marketplace, and have therefore repealed them in most jurisdictions. However, legislative action by states on making policy cancellation and nonrenewal requirements uniform among the states has been nonexistent. For a typical large commercial and industrial enterprise that has facilities in multiple states, it is difficult for corporate risk managers, chief financial officers, and others to understand the inconsistencies and attempt to work with them. As for another area of insurance regulation, states still maintain their retaliatory taxes, fees, and other charges.

Removal of filing requirements for insurers' products is not a new concept. More than 20 years ago, states such as Arkansas and New Jersey specifically exempted certain kinds of commercial insurance policies from having to be submitted to them for information, review, or acceptance. Virginia followed them a year later with a rate filing exemption for some of the same types of business. Rationale used by the insurance regulators for the implementation of the exemptions was similar. Following are pertinent excerpts from their deregulation announcements:

> Arkansas:
> That filing and approval of the documents or forms cited . . . is not desirable or necessary for the protection of the public. (Order A.I.D. 82-25)

> New Jersey:
> Those commercial lines insurance risks . . . are found to be special risks which are of an unusual nature or high loss hazard or are difficult to place or rate. (Public Notice effective 1982)

> Virginia:
> The requirements of filing certain rates, rating plans, and rules for those classes of non-commonplace hazards . . . should be suspended . . . for the reasons that the marketplace for such insurance is highly competitive, the insureds therein are highly sophisticated insurance consumers and the risks to be insured are non-commonplace hazards. (Administrative Order 8301)

Note the variety of reasons given as a basis for granting an exemption:

- unusual nature of risks
- difficult to insure
- very competitive market
- sophisticated buyers

Continued on page 10

Commercial Lines Deregulation Revisited

Continued from page 9

All reasons demonstrate why traditional insurance regulation of commercial price and coverage is inappropriate and unnecessary. These exemptions pertain to very large and complex commercial and industrial properties such as a chemical manufacturer, a high-rise office complex, and an integrated steel mill, but not to the corner drugstore, garden apartment units, or a fast-food palace.

Here's another example of insurance product deregulation that has been in place successfully for a long time: Illinois. No rating law has been there for decades, yet there is no absence of insurance companies willing to do business there using competitive prices. The State Insurance Department of Illinois still has the authority to conduct audits of insurance company practices and to protect the interests of consumers, which they do.

More recently, the Pennsylvania legislature enacted a law to give the insurance commissioner authority to exempt forms from filing requirements. Notice subsequently issued by the insurance department exempted 19 specific lines of business including:

- aircraft hull and aviation liability
- inland marine
- kidnap and ransom
- fidelity and surety
- boiler and machinery
- highly protective risk policies

But progress on reducing or eliminating requirements for the submission of commercial coverage and rating revisions has been a mixed bag of results for insurers. During the writing of this article, the Massachusetts legislature is on the verge of enacting legislation. A proposed law would allow large commercial policyholders (defined as a business with property and casualty insurance, other than workers compensation, with a premium over $30,000 plus some other criteria) to purchase deregulated insurance products. Yet the Washington State Insurance Department is also now in the process of increasing the requirements for commercial policy rate

deregulation. New Hampshire, as of January 1, 2004, changed its definition of a large commercial policyholder; it is debatable whether the revision is an improvement in the speed-to-market concept of insurance regulation.

When there have been filing deregulation standards introduced, they also have been a mixed bag. Variables are generally the premium threshold used and the exemption paperwork involved. Premium amount at which a filing exemption applies for a product submission varies by jurisdiction from $10,000 to $500,000. Interestingly, some of the smallest states have the highest dollar threshold. Therefore, because higher valued exposures (generating larger premiums) are often located in the largest states, the practical effect of the exemption standard is that little if any business is eligible for it.

Paperwork requirements for a filing exemption to be used can involve the producer, insurer, policyholder, and others. Among the stipulations in about a dozen states for an unfiled rate or policy to be used are that all or some of the following criteria be utilized:

- producer involvement with the insurance transaction
- insurer notification to the insured and the state in writing of the exemption
- customer signature on a detailed certification that it qualifies for the exemption
- a CPA certification that the business qualifies for the filing exemption standard.

> ■ *Another deregulation variable is that some states have lifted filing requirements just for pricing or only for coverage.*

What's required varies by state, but policyholders have told their insurance carriers that the only paper they want to see is the policy, not some certification form to be completed.

Another deregulation variable is that some states have lifted filing requirements just for pricing or only for coverage. Consequently, it creates an untenable situation with an insurance company being able to offer only part of a new or revised product, while having to wait for acknowledgement or acceptance from regulators for the other part. Effect of that situation is that the product cannot be sold, so the deregulation again is theoretical rather than practical.

Final observation: to date, there are a few states that implemented real deregulation of various parts of the commercial insurance process many years ago, and other states could look to them for a successful model to follow. ■

NAIC and the 21st Century Insurance Regulation

Therese M. Vaughan, Ph.D., CPCU, became Iowa Insurance Commissioner in 1994, and has been an active member of the NAIC, serving as president in 2002. She currently chairs the NAIC's Governmental Affairs Task Force and the Terrorism Risk Implementation Working Group; and co-chairs the Risk Assessment Working Group. Prior to becoming Insurance Commissioner, Vaughan was the director of The Insurance Center and chair of the Insurance Department at Drake University in Des Moines, Iowa; and was a consultant at Tillinghast, a Towers Perrin Company. Vaughan held previous academic positions at Baruch College of the City University of New York and at Temple University. She earned a Ph.D. in risk and insurance at the Wharton School of the University of Pennsylvania, and a B.B.A. in insurance and economics at the University of Iowa. She is a CPCU, an associate of the Society of Actuaries, an associate of the Casualty Actuarial Society, and a member of the American Academy of Actuaries; and is a co-author of two college textbooks on insurance. A 1994 article coauthored by Vaughan was recognized as the outstanding article of the year in the *Journal of Insurance Regulation.*

Editor's Note: The CPCU Society's Central Illinois Chapter hosted Iowa Insurance Commissioner Therese M. (Terri) Vaughan, Ph.D., CPCU, at the November All-Insurance Industry Day. Vaughan provided insight into the activities of the NAIC.

In March 2000, the NAIC issued the following Statement of Intent:

> Insurance regulators are committed to modernize insurance regulation to meet the realities of an increasingly dynamic, and internationally competitive financial services marketplace.

A reinforced commitment was announced by the NAIC in September 2003 stating in part, "We are proud of what has been accomplished . . . but more dramatic advances in unifying state regulatory processes are needed . . . "

Commissioner Vaughan stated the NAIC has identified the following regulatory modernization priorities: producer licensing, speed to market, market conduct, financial regulation, insurance company licensing, changes in insurance company control, and consumer protection. An aggressive action plan is in place and progress is being made by multiple working groups with aggressive deadlines that include participation by commissioners and broad input from industry, consumer groups, and other interested parties.

In the area of producer licensing, Commissioner Vaughan shared NAIC's vision to create a streamlined national producer licensing system with a "uniformity of forms and process." She explained this requires reasonably uniform laws and centralized electronic processing. The uniform producer licensing model was adopted by the NAIC in September 2000 and since then 50 jurisdictions have enacted producer licensing legislation. Only New Mexico has not yet enacted producer licensing legislation.

Another area Commissioner Vaughan discussed was the NAIC's speed-to-market vision: interstate collaboration and operational efficiency. The NAIC supports developing a one-stop filing system for products issued on a multi-state basis where appropriate. For lines that do not lend themselves to uniform standards, the NAIC is "committed to reviewing market barriers for further efficiencies . . . and to shift focus away from a prior approval system where appropriate." This will require operational efficiencies to improve transparency of product standards and filing requirements, a uniform transmittal form, a system for electronic rate and form filing, timely review of product filings, and a self-certification process. A regulatory framework will also need to be in place for these efficiencies to be gained.

The final area Vaughan reviewed in her presentation was market conduct.

"The NAIC recognizes that the marketplace is generally the best regulator of insurance-related activity. However, there are instances where the market does not properly respond to actions that are contrary to the best interests of its participants." She further stated, "Market analysis, market conduct examinations, and interstate collaboration are the three pillars on which the states' enhanced market regulatory system will rest." The NAIC has several initiatives regarding market conduct:

- developing tools for a market analysis function; implementing market analysis in the states
- implementing uniform procedures in exam scheduling, pre-planning, examination procedures, and exam report; leverage to use automated exam techniques
- promoting interstate collaboration in market conduct, including domestic deference
- coordinating activity on market conduct problems through the Market Analysis Working Group

The NAIC supports targeted national uniformity. The NAIC Statement of Intent adds "certain aspects of the insurance industry deserve a national system of regulation." A national system to address national issues such as producer licensing can be created while maintaining the ability of the state system to address local issues.

More than 750 attendees appreciated Vaughan's presentation as part of the annual Central Illinois Chapter All-Industry Day events. ■

Regulatory & Legislative Section Quarterly
is published by and for the members of the Regulatory & Legislative Section of the CPCU Society.

RLQ Editor
Eric C. Nordman, CPCU, CIE
National Association of Insurance Commissioners
Phone: (816) 783-8005
E-mail: enordman@naic.org

Regulatory & Legislative Section Co-Chairman
Eric C. Nordman, CPCU, CIE
National Association of Insurance Commissioners
Phone: (816) 783-8005
E-mail: enordman@naic.org

Regulatory & Legislative Section Co-Chairman
Damian V. Sepanik, J.D., CPCU
Regulatory Attorney
Phone: (847) 277-1092
E-mail: dsepanik@aol.com

Sections Manager
John Kelly, CPCU
CPCU Society

Managing Editor
Michele A. Leps, AIT
CPCU Society

Production Editor/Design
Joan Satchell
CPCU Society

CPCU Society
720 Providence Road
PO Box 3009
Malvern, PA 19355-0709
(800) 932-2728
www.cpcusociety.org

CPCU Society
INSURING YOUR SUCCESS
Celebrating the Past, Shaping the Future

Regulatory & Legislative Quarterly

RLQ

Volume 12 Number 1 March 2004

CPCU Society
720 Providence Road
Malvern, PA 19355-0709
www.cpcusociety.org

PRSRT STD
U.S. POSTAGE
PAID
BARTON & COONEY