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INSURANCE REGULATION – EVOLUTION OR REVOLUTION?

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Representatives of regulators and the industry will discuss the evolution and current status of industry regulation and offer perspectives as to how that process is and will be changing to address future industry dynamics.

- Status of regulation in the United States
- Notable failures and successes
- State regulation versus other alternatives, e.g., federal-state
- Industry risk management
  - Prevention of business failures
  - State guarantee fund issues

MR. EDWARD L. ROBBINS: I am a principal with KPMG Peat Marwick. John Angle is the retired chairman and CEO of Guardian Life. He is still a member of the board of Guardian, and he is president of the well-known industry newsletter, *Probe*. He will talk about a vitally important issue that has been in *The Wall Street Journal* lately: problems with life insurance companies owned by holding companies.

Bill Carroll is the actuary for the American Council of Life Insurance. Bill covers all statutory financial reporting and reserving matters for the ACLI.

Terry Lennon is the chief examiner of the New York Bureau of Insurance, and he has indicated that he will wrap around what Bill has said, and fill in where he feels it is appropriate.

Evolution or revolution in the insurance regulation area is a provocative title. What does it mean? Are we moving at about the same pace we have in the past? That would be evolution? Are we moving faster than that or are we even moving in a quantum amount into some watersheds that are happening upon us extremely quickly. It is very difficult to tell.

I just want to excerpt for a moment something that I thought might be of interest to you. Representative Norman Lent, the Republican congressman from New York who is basically the ranking Republican on Congressman Dingell's House Energy and Commerce Committee, spoke to the property and casualty side of the industry, the National Association of Independent Insurers (NAII), in Washington, on March 4, 1991. By the way, this was the committee that came out with that now famous insurance industry "Failed Promises" report. I am just going to excerpt a couple of passages from his speech to give you the flavor of where Congress may be heading.

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> You no doubt already know that our Subcommittee on Oversight and Investigations has been looking into the insurance solvency subject for almost three years. While the case studies of the largest insolvency summarized in the report point out weaknesses in aspects of state insurance regulation, there would not be as much interest in solvency issues were these case studies just isolated incidents. There was growing interest in and serious concern about insurer solvency because, in addition to the "Failed Promises" report we have seen, among other things [and I will just mention four of these so-called other things in the speech] several insurance rating organizations have downgraded the ratings of some major insurance companies; second, the Insurance Services Office concluded that the property/casualty industry as a whole is under-reserved by $10 billion; the solvency issue is front-page news, in major publications from *Business Week* to *Barron's* to *The New York Times* to *The Wall Street Journal*; and all of this is happening against the backdrop of problems in other financial institutions, most notably banks and savings and loans.

In the last 30 seconds of his speech, he says:

> In the end, Congress will not decide whether a federal role in insurance solvency is needed on the basis of philosophy, but largely on the pragmatic basis of whether the states and the industry have truly taken it upon themselves to make state regulation as strong as possible.

MR. JOHN C. ANGLE: I want to recognize that there is a very free market for ideas in this country, and that in all businesses we have to choose between regulation by the market and actual regulation; we, of course, opt for solvency regulation because the soundness of the insurance business is so important to what we do and to our public trust. But, I think as we talk about the successes and failures of regulation, we have to recognize the number of influences that have reshaped the life insurance business almost beyond recognition. These influences have been, by and large, beyond the control of state insurance regulation. As I go through them, I think you will see that many of these are parts of a huge tide of managerial fashion that swept through the business community, and also swept through, I would say, the consulting community and academia.

Let me give you the seven, along with an example of each one. The first one would be the coming of insurance holding companies, which occurred in the years 1967-69. Those of you who have gray hair will remember that at that time Superintendent Stewart appointed a commission on holding companies chaired by Oscar Ruebhausen, and the commission came back to the superintendent and said, "We think holding companies are a very bad idea, although we recognize that there are pressures for diversification, and perhaps those can be accommodated within the framework of the stand-alone insurance company."

The tides, however, were running very deep. It became a charge led by the attorneys of the industry, and Sears Roebuck and The Travelers and many others succeeded in getting holding company laws adopted in New York and in all states. There were three immediate results and more than 300 insurance holding companies were formed within a short span of time. Long-term insurance management of stock

life insurance companies sold out at a tidy profit, thank you. The stand-alone stock life insurance company disappeared. The professional manager came to insurance business, along with a few people of the type that Senator Metzenbaum refers to as wheelers and dealers, and a new era began. The holding company, I think, also removed some of the focus once given the management of the insurance subsidiaries.

The holding company legislation that was originally put in place did reserve to the states the right to approve the purchase of an insurance company by a holding company. New York had a tougher law that was ultimately adopted by the NAIC. It said that if there were going to be any transactions between the holding company and the subsidiary, the states should have advanced notice and 30 days to veto the transaction. As of January 1, only 15 states had enacted those provisions. There are also model NAIC bills dealing with reinsurance that have passed muster in even a smaller number of states.

The second development, I believe, was the coming of GAAP accounting, also a creature of the 1960s. It was intended to reveal the hidden values in life insurance company balance sheets to investors, and particularly the security analysts, and I think in the beginning, it did that very successfully. However, the basic premise of GAAP accounting is a going concern variant, and I think in the eyes of an actuary, the only contingencies dealt with that might befall a company that are reflected in the GAAP statement are that mortality might get worse than predicted. There might be a deviation in lapses on a block of business, or a deviation in interest earnings. However, some of the more serious contingencies that can arise, particularly when one of the new ideas takes hold, are ignored. Last year, the *Value Line Investment Survey* recommended long-term investment in both the Monarch Capital Company and in the First Executive Corporation. Suddenly it stopped following the stocks altogether. But I have to wonder how well the financial statements of these companies illustrated the state of affairs at least to the security analysts who were trying to follow those stocks on behalf of hundreds of investors. The investors obviously, in those situations and others, lost heavily, and perhaps they are the ones, rather than John Angle, who should be raising a hue and cry.

The third trend was that of conglomeration which may have been behind the holding company movement in the first place. You remember that Textron with Royal Little, and ITT with Harold Geneen, really evoked a frenzy of diversification. Diversification was supposed to produce stable earnings, economies of scale, and the benefits of professional management. In my mind's eye I still see Harold Geneen sitting on a dais which looks like the senate hearing room with his people beside him as they grill one of the managers from the almost 300 businesses that ITT was trying to follow. The judgment now on conglomeration and this kind of diversification is that it hasn't worked.

The most critical judgment of conglomerates appeared in the London *Economist* a couple of weeks ago. It called the whole conglomeration movement a colossal failure. *The Economist* noted that United States business had loaded itself up with an extra layer of corporate overhead at exactly the same time that the Japanese who operated with leaner management structures were coming into the world market, and who went on to gain market share at our expense.

Now, of course, academic thought has changed completely. Streamline operations, get down to the core businesses, they say. Looking back we see that conglomeration was possible for insurance holding companies, and for mutual life companies that were empowered to diversity by the Holding Company Act. We had here the same fantasy that by diversifying into businesses one didn't understand, that one somehow strengthened the operation.

The fourth trend I would mention involves two Nobel prize winners, Franco Modigliani and Martin Miller, both of whom I think have been president of the American Finance Association. These academics found that the mixture of the capital of a corporation, the debt/equity mixture, made no difference at all in the market performance of its common stock. They found, as a matter of fact, that those corporations that had leveraged themselves enjoyed the significant tax benefit of being able to deduct the interest on the capital and thus got their capital at a lower cost than those who relied solely on equity. This produced better earnings for the leverage of corporation, and it was clearly the way to go.

The leveraging of the insurance holding company was certainly a derivative application of a theory that was developed for nonfinancial corporations. I do not believe that there has been any attempt yet to really understand the inherent instability of a leveraged holding company that invests in insurance subsidiaries.

When you look at the statutory statement of the life insurance subsidiaries, you would obviously see only equity. That's because any debt that's on the balance sheet of an insurance company is subordinated as a surplus note. However, when you go upstairs to the holding company, you may see a lot of debt. And it is impossible, at least to a casual reader, to tell how heavily or how instable the financial structure may be. Again, I think this is beyond the regulation as we now have it.

On the banking side, bank holding companies and the federal banking laws have taken a more conservative approach. Bank holding companies such as Citicorp are subject to regulation. They are subject to the same capital requirements, that is nondebt capital, that would apply to individual banks. Those capital requirements are based upon the aggregate assets of the banks owned by the bank holding company. If the bank holding company happens to be Citicorp, which also owns a financial guarantee association, there is a step-up in its required capital in order to cover that risk.

So, I think we have had the Miller and Modigliani encouragement to leverage, along with GAAP accounting, an import to the insurance business, and a major management tool of boards of directors and managements. The professional managers of holding companies have not always understood that life insurance companies do not necessarily have predictable cash flows. You can't necessarily count that there will be money available for dividends, and I think this variability is also poorly understood by investors.

I would make three other points before surrendering the podium to my learned colleagues. One is that insurance managements have not been immune from the American emphasis on short-term results. I think American business, including the insurance business, spends millions of man hours trying to think through quarterly

results, and very precisely measuring progress against a one-year plan. CEOs, by and large, find themselves under incentive compensation schemes put there by directors who are presidents of other companies who have the same sort of schemes. The long term becomes two years, and little thought is given clearly to the time spectrum that actuaries have traditionally addressed.

We are certainly in an era in which there appears to be at least adequate capacity in the insurance business and extreme price competition. I do not know how much of this is the result of a misunderstanding of the economics of life insurance and how much of it is because of too much capacity to be put to work. All of this, however, complicates regulation, and especially regulation which in a day of less direct price competition, could resort to delay and expect things to work themselves out.

I think the final point that needs to be mentioned is that when one talks about leverage and the leveraging of holding companies, you have to recognize that reinsurance itself has become a technique of leverage. Reinsurance means both within holding companies and without, and it obscures the fundamental risk-bearing capacity of an insurance enterprise. It means regulators have a very complex task of analysis sorting out which companies should be allowed to continue to compete in the business and which should be taken back for a retooling.

Events of the last three or four months have disturbed our tranquility. The public is concerned that something is very wrong. There undoubtedly is, both in Washington and elsewhere, a great demand for quick results. There are some things that can be done quickly, and I know my fellow panelists will discuss them. But the trends I have mentioned lie behind many of the troubles that we are now facing. I suppose we can create regulations as we sometimes do in the army by picking a battle plan that would win the last war, but I think we have to be careful about overreaction. Let me leave you at that point. Does your state comply with NAIC financial regulation standards? Has your state been accredited by the NAIC? Unless you are from New York or Florida, the answer is, your state is not accredited. What are these NAIC financial regulatory standards and what might be the consequence of being domiciled in a state which is not in compliance, which has not been certified? I will return to these important questions after an introduction.

What is the status of regulation in the United States? Before we can address that question, we have to ask what the status is of the life insurance companies being regulated. My opinion which, not surprisingly, coincides with the opinion of my employer, the American Council of Life Insurance, as expressed by a recent ACLI task force, is that margins are smaller, risk is greater, but the life insurance industry is still basically sound. Now, obviously, some companies have taken risks that they may not or will not be able to cover, but as a whole, our business is sound. We should not be afraid to say so to people. We believe that. The ACLI task force concluded that the industry ought to continue to support state regulation of insurance, but that the regulation needs to be strengthened. In response to the pressures, the NAIC leadership has also looked at themselves and their work. Their response to concerns raised over solvency has been a well-organized, comprehensive approach conducted over the past three years, and is still an ongoing matter of the highest priority. (Did I really say that?) The centerpiece of that activity has been the financial regulation standards and their accreditation program. Let me read to you a paragraph from the

introduction: "A system of effective solvency regulation has certain basic components. It requires that regulators have adequate statutory and administrative authority to regulate and insure corporate and financial affairs. It requires that regulators have necessary resources to carry out that authority. Finally, it requires that insurance departments have in place organizational and personnel practices designed for effective regulation."

As I indicated, the program has three parts. The first part is a list of laws and regulations that ought to be adopted in the state if the state wishes to be accredited by the NAIC. Let me just mention some of the titles of the fourteen or so items that are required on that list. There should be examination authority, capital and surplus requirements, accounting practices, and authority to take corrective actions when necessary. The list also includes rules and regulations regarding investments, holding company systems, risk limitation, assets, liabilities, reserves, reinsurance, independent audits, new actuarial opinion, matters pertaining to receivership and guarantee funds, and lastly, one of my favorites, a requirement that companies participate in the NAIC insurance regulatory information system (IRIS). But the list of laws and regulations is not the real heart of the NAIC program. The real heart of the program is an objective to take the life insurance and to take the insurance departments that we knew in the past, and turn them around into places where competent, well-organized professional people are doing financial analysis and are doing examinations of companies, looking for the things that ought to be looked for. The standards come down to three things: a state needs to have authority; it needs to have good financial analysis practices; it needs to have good, well-trained, motivated people who are proud to be insurance regulators, and are respected by those that they regulate. The onset part, this will cost money. The money will have to come from our companies, from our policyholders and stockholders.

Before I give you the wrong idea, I don't want you to conclude that I believe that this problem is the be-all and end-all of financial regulation. Of course, it isn't. There is a lot of work to be done, but it is important to sit back for a minute and look at the NAIC from the top down, trying to get a broad view of what it is doing. I spend most of my time working with the NAIC, complaining and bickering about little details. We don't like this. We don't like that. They are doing this wrong. They are going in the wrong direction on this. They are doing things in secret, which we don't do in the United States. If that's your only view of the NAIC, you will conclude that things are all messed up. It means what is always meant; no action is contemplated. But, if you take a more broad view and look at what the leadership has been doing for the past three years, you will see that they have been putting in place a framework for getting their job done; a framework for encouraging states to do their job well. As I said, there are still a lot of things that need to be done. Some of the more important ones are the asset valuation research, risk-based capital requirements, the new valuation actuary requirement, a whole new set of investment laws. The NAIC currently does not have a comprehensive set of investment laws. It needs to have a revisitation of reinsurance accounting.

These are just a few of the ongoing things. I began by asking if you knew if your state was accredited. Recall that only two states have been certified by the NAIC, New York and Florida. I also asked if you knew the consequences of your state not being accredited. As yet, that is unclear, but it has the potential to be a severe

disadvantage if you or your client's company is domiciled in a state that is not accredited. How can that be? It's zeal. The NAIC is considering adopting a licensing of foreign insurers model act. This act is in order for adoption in June. If a company is domiciled in a nonaccredited state and is doing business in a state that had passed this proposed model, New York or Florida for example, admittedly a hypothetical example, then for every intent and purpose, the company would be treated by the state which had passed the proposed model as if it was domiciled in that state. For example, if Florida passed that model, and you are working for a non-Florida company doing business in Florida, Florida would your company as though it were a Florida-domiciled company. If several other states passed that kind of rule, you would be treated according to the current wording that is in order for adoption in June; you would be treated as though you were domiciled in each and every one of those states. Now that is, I'd say, practically impossible, probably impossible, and certainly very expensive.

I can tell you that Florida, one of the two states that has already become accredited, is very active in supporting strong solvency requirements. Now the NAIC has a good intent in this regard. It wants to put pressure on states to comply with its program. It wants to force insurance companies to put pressure on their commissioners and their state legislators to make sure that their state is in compliance, and this is important for the states. If we have to choose between state regulation and federal regulation, and if we come down as the ACLI has, in favor of state regulation, then we have to be willing to stand for sound state regulation. A part of the historic state regulatory scheme in this country is that states put the primary focus on their own domestic companies, and pay much less attention to the activities of foreign companies within their state that impact their citizens. In order for this kind of scheme to work, state regulators have got to be able to rely on commissioners, regulators, laws, rules and regulations of their sister states, so it is appropriate for them to put pressure on the other states. Let's all do this together. We all do it together or we all fail separately.

You might say that kind of a law will never be adopted, and if I was betting, I would say it wouldn't. It may well get adopted by the NAIC. But, the same thing can be done and has been attempted on a smaller scale. The NAIC examination rule says that you have to be examined from time to time by your state and by examiners working on behalf of another state who may be together in the examination. The current NAIC version of that rule, which has already been introduced in the state of North Carolina, says that after a certain time in the future, if the examination isn't conducted by an examiner who is working under the authority of an NAIC-accredited state, then it doesn't count.

There is a further example of the NAIC stretching out and using its authority to get done what it perceives to be good. In December 1990, it adopted a new version of its audit rule requiring independent CPA audits of a financial statement. It didn't stop with just adopting a new model rule. It took the requirement for an audit and incorporated it into the annual statement requirement. What it hoped to accomplish by this was to, depending on your persuasion, you might say circumvent, preempt or avoid the need for state laws or regulations on the matter. At the time it did this, less than half of the states had an audit rule requirement. By putting in the blank, it is their opinion that it becomes a requirement in those states because those states

already have in place laws and regulations that say that companies doing business there must file annual statements. They must use the NAIC form; they must follow the NAIC instructions. This is the place where the NAIC essentially has the force of law. It can take action through the blanks route as it did last year when it established the mandatory securities valuation reserve (MSVR) standards, and that action automatically becomes effective without the need for state regulations or state laws to be enacted.

What is the status of state regulation? They are state regulators. They try harder. What are the prospects for federal regulation? I don't know, and I don't make a living trying to guess. I can tell you what you should watch. You should watch for activities regarding repeal of McCarran-Ferguson and you should watch the activities of the Dingell committee. How the First Executive problem is worked out will have an enormous impact on the attitude of federal regulators and of those who wish to impose federal regulation.

A second important factor is how the industry is able or not able to maintain a united position on these matters. Here I mean property/casualty, life insurance, large company, small company, stock company, mutual company, agents, and if I have left someone out, I apologize. The entire industry must be united in order to have an important influence on what happens. This is no different than the federal income tax matters.

Has insurance regulation been successful? And, again I cop out; that depends on what you perceive the goal to be. If you think that the goal of insurance regulation is to prevent insolvency, then you must conclude that from time to time it has failed, and you may sum up the failures and decide whether this is a minor failure or another failure. But, I don't believe that's a proper goal. To prevent insolvency is impossible. We shouldn't have goals that are impossible, but also, to prevent insolvency is undesirable. In a free economy, dynamic competition is necessary. It is necessary to sort out ideas. It is necessary to find out what works and what doesn't work, and insolvency is one way of getting rid of ideas that don't work. The price of a zero insolvency policy is too high. I believe a goal of insurance regulation, at least with regard to solvency, might be better stated to minimize the impact of insolvency without undue control over the free marketplace. Now that I have stated the goal, it is fair to ask me, well what do I think? Has it been successful? Let me answer you this way. If someone was willing to supplement my retirement, let me go off to a nice pleasant place and sit and write a book about the history of the life insurance business in the twentieth century, I think an appropriate title for that book would be *One Hundred Years of Kept Promises.*

MR. TERENCE LENNON: I think John went through a considerable list of some of the things that have gone wrong over the past 15 or 20 years, and I think few would doubt that this is an entirely different industry than it was in the early and mid-1970s and all the time before that perhaps. The rapid rise in interest rates in the late 1970s and early 1980s, the turnover to interest-driven types of products and the fact that they eventually came to be sold like commodities, the squeeze on margins and the resultant effects on capital, and the steps that were taken to mask rather than fix the effects on capital, all come home to haunt us as we turn into the last decade of this century.

There are major names in question. We all know that several months ago there was a wire story that spread like fire one day. One of the major insurance companies was going into bankruptcy. I mean, it was a ludicrous story. An insurance company doesn't even go through the procedure of bankruptcy, so even in its own terms, it was ridiculous. But there was a lesson to be drawn from it, and that is that if you go back 15 years, that story would never have appeared on a wire. It would have been stopped before that because it wouldn't have been a plausible story. I believe that the fact that that was a plausible story in 1990 is a commentary on the industry, and that is certainly why regulation is being looked at at this time.

We have recently seen Executive Life and First Capital in the news. I think in *The Wall Street Journal*, there was the name of another top 20 company, indicating that it was stressed. I don't think you are going to see the end of that. As long as that's in the news, I think we'll be down in Washington. I do see the light at the end of the tunnel, and I seriously hope it is not a train. I think that what you are going to see in the 1990s is a lot of consolidation, a lot of restructuring. You are going to see fewer companies, perhaps as much as 20% fewer companies than existed going into this decade.

I think the companies now are coming to the realization that they can't be all things to all people, that they better find out what they do well, because that's the only way to survive. You can't do 30 different things well, because you probably don't know what 28 of them are all about. You are trusting people who you bought with the enterprise, and that has been an unfortunate experience for a lot of companies. I see a refocusing on the part of the industry which I think is healthy.

I also see a realization that companies had slipped into that uniquely P&C malaise, cash flow underwriting. They got into an era when they really weren't sure what the margins were on their new products. A lot of companies were being carried by their old book of business. I think we see now a refocusing on the assumptions going into writing new business.

I think we see management restructuring which is of critical importance. I think that the old management structures that were in place and which worked well in years past, no longer work. I think that those management structures were characterized by a series of autonomous or semiautonomous functional units. The marketing, investments, and actuarial units were separate. They talked several times a year, put things on automatic pilot, and it worked pretty well.

That structure doesn't work anymore. There has to be a continuous dialogue and a continuous monitoring. The CEO has to get advice from the marketing people, the investment people, the pricing and valuation actuaries in order to make an intelligent decision of any kind. There must be continuous feedback on how the assumptions that were made are working. I think that through the 1980s a lot of money was put into EDP systems. Unfortunately, I think more of that money was put into policyholder systems than management information systems. I think we are in an era now where management information systems are absolutely critical to running a business, but I do see again the beginnings of companies getting into that and creating those systems.

So, all in all, I am somewhat optimistic going into this last decade of the century. I think that there are an awful lot of discussions going on about mergers. They are not taking place yet. I think eventually the dam will break and they will be taking place. It simply makes economic sense. I don't think all of those companies have all the new management structures and the capital in place, and very often, two of them together will get done what one alone will not. I'm not sure what has to take place. I suppose in some respect what has to take place is that the pain level has to increase. That's unfortunate too, because for the most part, companies are better able to negotiate those things when the pain level is lower than when it has gotten to such a pitch, and there really are not a lot of options left. That seems not to have been a realization generally accepted yet, but I would hope that people will dwell on it and see that it makes sense to do those things early while both companies are still in a relatively healthy condition and have something that can be really built on.

The most glaring failure I think is the lack of even distribution of regulatory resources. There are no actuaries in many states; not many who can read a reinsurance treaty, certainly not a complicated reinsurance treaty. They have a great deal of difficulty with the more complex holding company transactions that they might be faced with. All of those things are no doubt weaknesses. There is an attempt to address them through the program that was outlined, regarding the certification of states. Go back to your companies with the message that that ought to be looked at, because I will be candid with you, you have more lobbying clout than we have. So if in fact, there is an interest in state regulation, you better go back and get your companies to support this legislation. I do think for a number of reasons state regulation certainly has performed better than federal regulation in almost anything that the federals have regulated.

However, the mere passing of some laws is not going to do it, because laws are not the sole substance of good regulation. People in insurance departments who understand the business and who can deal in a realistic way with the problems that you present them are also needed for good regulation. That's something that takes quite a while to build, but it doesn't get built if you don't lay the foundation, and I would suggest that the foundation is now ready to be laid. In New York, I do believe that we have been generally successful. I think that we have stayed ahead of the curve on most of the things that are potential problems. We had asset liability matching in 1986 under Bob Callahan, that was the date the regulation was adopted. The work began years earlier, so we were relatively early in the decade in doing what is something that I have from time to time characterized as being suicidal not to do if you write interest-sensitive business. I hope the fact that it is not required in 49 states has not deterred most of you from doing it in your own companies anyway.

The New York Insurance Department issued a junk bond regulation in 1987; that was after trying to get it through the legislature. That was at a time when junk bonds were everyone's darling, and we were the odd man out. The legislature didn't seem inclined to do it. So we promulgated a regulation that at least has helped, but not prevented, our current circumstances. Early in the decade again, 1985, we adopted a financial reinsurance regulation. I know this is something a lot of you are not going to like to hear, but financial reinsurance is not good. Today there would be a fully, completely and thoroughly insolvent Executive of New York, if it had all the financial reinsurance that we made it get rid of. It played a major part in both the California

company and in First Capital. As a matter of fact, it might have been the proximate cause of First Capital's immediate problem, that the California department finally pulled the rug out from financial reinsurance. They are not licensed in New York, so I am guessing at that. I have not seen their statements, but with all of these problems, these are companies that also engaged in financial reinsurance, to a great extent, to give themselves further ability to write. And when they fail, the failure becomes much greater. If it gets to the guarantee fund, you are all going to pay for that financial reinsurance.

As I said, I'm sure I've made a few enemies here, but we think it's one of the things that we did early in the decade that made a lot of sense. It was adopted by the NAIC immediately after that, and I believe that very few states have adopted the regulation. I must say that the other difficulty is that most states don't have anyone who can read those treaties and make a decision. That is a difficulty that has to be overcome. I think that many of these things have been transferred to the NAIC. I think a lot of the things that Bill mentioned are going on at the NAIC now.

I think that there is a more intense participation on the part of both industry and regulators than there was say 20 years ago. Twenty years ago when I first started going to NAIC meetings, the NAIC was essentially the big companies regulating themselves. They would write the model bills. They would write them in a way that was reasonable, but didn't interfere too much with the things that they wanted to do, which were, for the most part, not terrible, so it wasn't awful. States like New York were observers. We participated in the blanks and maybe in the actuarial groups for the valuation standards, but for the most part, we were not fully engaged in the other things. I think that has changed. I think that the stresses in the industry in the 1980s have made the regulators more active. This is no longer a time when a long bill is going to be written by the industry and simply be adopted, I don't think, not on an important subject anyway.

I have already told you about some of our experiences in Washington. The feds have not demonstrated any particular aptness at regulation. They simply haven't. Even when you look at the numbers, it is not a particularly good comparison from the standpoint of the feds. There have been far more sizable bank failures, not just S&Ls, but commercial banks, than there have been insurance failures. You know, the Dingell report, which was frankly all property and casualty, was very entertaining. It was very well written, and it outlined, I thought correctly, some of the most egregious examples of what property and casualty insurers can do to screw themselves up. But, what he did is rather dangerous. He tried to paint the whole system with this broad brush that he made out of the most egregious examples that he could find of a relatively small part of the industry.

In the case of life insurers, I think there were something like 43 failures in 1989, but I think in 1990 it returned back to 19. Most of these were companies that were so small that I didn't even know the names of them. I had never heard of most of them, and they were generally one-state and two-state companies. In terms of the 2,500 companies that are licensed life insurers, and in terms of the total premiums written, they were really insignificant. The bottom line is that people throughout this country still make out a check to an insurer without giving it a second thought, and as we have pointed out in Congress, you have to give both the industry and its

regulators some credit for this because it is not that way all over the world. The failure of Executive Life and First Capital represent a change that must be watched.

We have travelled a number of times to Asia recently, and other than in Japan, insurers are not widely trusted. That's a jewel that the insurance industry here has, both P&C and life, that it ought to be smart enough to protect. Frankly the way to protect it is with more rational and stronger regulation. The business of deregulation during the 1980s simply didn't work. Whether it makes sense to have one regulator versus many, I will leave to you to decide. Actually, in the S&Ls, I think that was bad. In fact, recently I have been thinking that in some respects, state regulation is a little bit like diversification in a portfolio. You get one big stock in your portfolio, and if it flies, you're a millionaire; if it doesn't, you are in poverty. The fact is that the S&L regulators made some terrible mistakes. They came out of the 1970s with a terrible mismatch on the part of their companies. They liberalized their investing laws I guess in the hopes that they would invest their way out of that problem. It turned out to be a mistake, they allowed any number of innovative accounting techniques to mask it for a while, hoping that it was going to get better. The fact is there was one group making these errors, and they spread throughout the entire system.

State regulation certainly makes its share of mistakes, but at least it has the balances and counterbalances, and when we go to NAIC meetings, we hear what Illinois, California, Texas and Florida think and what they are doing about things. We have the benefit of hearing from companies that are licensed in other states. As many of you know, we recently started an overhaul of Section 4228, the section of New York law which limits commissions. When we were doing our brainstorming, we invited a company that wasn't licensed in New York to give input in the brainstorming session. I think that a variety of opinions very often produces a better product. That's just another reason for not going to federal regulation.

I guess the last item on the agenda is industry risk management, failures and the guarantee funds. I would agree with Bill. The aim of this system is not to prevent failures. As a matter of fact, the price of a system like ours is a certain amount of failure. Again, on our trips to Asia, we were struck by the fact that they regulate from a different perspective, and the perspective is that there should not be failures, and what that means is setting everything so that the least efficient company thrives. That obviously lets the most efficient company thrive very well, but it delivers very little in the way of value to the consumer.

Our system is obviously geared toward balancing value to the consumer with safety to the consumer. The consumer wants all of both, but you can't have all of both, so essentially what we have is a system that tries to balance it. A system like that will inevitably have failures. You hope that you keep them to a minimum, and you hope when they do occur that they are not egregious failures. The guarantee fund system is to be a net for that. That's what it exists for. If we regulated so that we didn't have failures, we would just do rate regulation, make sure everyone charges very, very high rates, and everyone would survive. That's basically the way it's done in a good part of the world. I am not as familiar with Europe, but in Asia, that's certainly the way it's done. But, it's a different system, and as I said, there are only two kinds of systems that would prevent failure. One is where the rates are kept so high that nobody is going to fail, and the other is totally saturated with regulation, and then it

becomes so expensive and I'm not even sure if that would stop a failure. Probably the only thing that can be done to really stop failure is just make sure that prices are so high that nobody fails.

All in all, if I were to summarize, I would say that the status of the industry at this point is stressed, but showing signs of recovery, and I would say that the status of its regulation is probably about the same. We're certainly stressed, and I think we are showing signs of recovery. Very often, what comes out of this are stronger structures, and I would hope to see by the end of this decade, both stronger companies and stronger regulation throughout.

MR. ROBERT J. CALLAHAN: I think the panel did a very, very good job. In the case of S&Ls, I don't think that there was anything that could have saved the S&Ls in light of circumstances beyond their control, with the increasing new money rates when they had such a tremendous mismatch of their assets and liabilities, being primarily a single product industry with fixed return, long-term assets and very, very short-term liabilities of cash on demand. There was no way that the industry could have been saved, and we might note that we have a very odd system of regulation of banks and S&Ls in that they can generally decide whether they want to be regulated by the federal government or by the state government, whichever suits their purpose. A good number of the failures of the S&Ls were regulated by states. However, I think a lot of people do not want to see federal regulation, the federal bureaucracy, so they're looking for some intermediate form. In particular, the Dingell Committee report made a recommendation all the way from federal oversight of a federal agency to a designating association of either a life insurance company or of state insurance departments to be given the authority by the federal government to rate. Now, I don't know whether you want to call it revolution or evolution, but in the three-year period that Bill Carroll mentioned, there has been a tremendous build-up at the NAIC of hardware, software, expertise of the personnel, and number of the personnel. They have changed an organization from primarily a social organization to a highly professional skilled operation, and as Bill Carroll says, this is being funded by the insurance industry, by direct assessments against the companies who filed their diskettes with the NAIC central office. Now, if the federal government gives the authority to the NAIC, perhaps the NAIC can in fact oversee the states in the accreditation.

Right now you mention two states being accredited. If only two states were accredited, it wouldn't be very effective, but there are a number of companies that are not licensed in either state, and if a company were licensed in both states, and didn't want to be regulated by either Florida or New York, they could just withdraw from those two states. So, let's say the number expands to 10 as a practical matter. Even with 10 states being accredited, there would be a good number of companies that would not be licensed in any one of the 10 states. But if a company is licensed in a state not accredited, but licensed in all ten of the states that are accredited, who decides what state goes out and treats that company as though it were a domestic state, to throw the cost of the operations of the insurance department against that state as well as all its domestic states? Now you are aware that in state insurance departments like New York, the field examiners' salaries are reimbursed by the company being examined. The overall cost of running the department is put into a pot and reimbursed by all domestic companies. Does this foreign-based company

then go into the pot too and be supported, or is there another alternative? What if the domicile state is not accredited? The NAIC professional staff can go out and pull the examination, and in turn then, the personnel and operations of the NAIC central law office is being funded by assessments against the company. I would like to ask Bill Carroll to address that situation.

MR. CARROLL: If I understand the question, you are asking me what I think of the situation where a company is domiciled in a nonaccredited state. There are a number of accredited states, and those states have also passed a provision that says if the company is not from an accredited state it will be treated like a domiciled company; or if it's just the examination rule we are talking about, the company will have to be examined by someone from a state that is accredited. First, let me say that I don't think that enough thought has gone into the foreign company model act that is now being considered by the NAIC. I also can't tell you about that thought because a great deal of the discussion took place in the executive session. Our organization is concerned about their passing any such model rule. Because of the importance of this kind of a program, we are concerned that even by a 50% vote, they can change some of these rules and requirements, and we plan to suggest that they might want to make a rule that says they have to have a two-thirds vote to make these kinds of changes. It's closer to constitutional law than to day-in and day-out law that we change with a 50% vote.

There is an alternative put forward by Allstate. One of the things that it has suggested is that if a company is in a nonaccredited state, it could select in much the same way that the Canadians have to select a port of entry, a particular state from amongst the accredited states, and it would be treated by that state as if it were a domestic. It wouldn't have to be treated by every other accredited state that way, and I think a tradition has grown that the Canadians use Michigan as a port of entry. That's not necessary. There may even be one Canadian company working out of Colorado, but the idea in the Allstate draft is that the company would be able to pick a state. It does afford the opportunity for that state to somehow charge money in the same way that it charges money to its domestic companies. I think there are a lot of details to work out, and I have no idea how this might go. It's an important issue that the NAIC should not address rapidly without thought. I hope I have given you some kind of an answer, Bob.

MS. BARBARA J. LAUTZENHEISER: I'd like comments from any of the panelists. Given that it appears that the politicians in Washington -- particularly Metzenbaum and Dingell -- who like this kind of thing because of the visibility they get, as well as the media which is playing it up more partly because of their own problems of selling newspapers -- are moving more quickly, because of First Capital and First Executive, what would you estimate the time frame that we have in which to get this three-part NAIC program implemented and strengthened, or probably better yet, the perception of its movement toward implementation of strengthening such that we can forestall that federal intervention?

MR. LENNON: Well I think a lot has to do with how Washington perceives First Executive and First Capital. I had said before these companies were placed into conservatorship that what was needed to get real federal regulation was a major life insurer insolvency. I didn't think the P&C side was ever going to do it. I think that

you needed people in a multibillion dollar company calling up and screaming "my life savings" to the legislators before anything was actually done. Now, I really don't know whether Executive Life will be viewed as a typical life insurer or as a maverick company with particular problems.

In the next couple of years, a steady number of states must be accredited under the NAIC system. We pointed out when this system was adopted that we could be hoisted on our own petard, because if it didn't get done, they would have given the feds the framework in which to attack. So I think that there has to be steady progress in getting states certified. My view is that the folks in Washington at this point in time don't have enough knowledge or information to really begin writing laws and regulating the life insurance industry. We are testifying in front of Dingell on behalf of the NAIC next Tuesday, relative to an audit that was done by the General Accounting Office (GAO) on the NAIC. So the NAIC is getting a lot of attention, and Bob correctly notes the build-up of expertise in the NAIC. So, there could be an increased role there, and I have a tendency to feel that at this point, that's more like what you're going to see. You're going to see some sort of legislation and maybe even a little agency that's developed to oversee the state regulation of insurance. That seems to me more likely as a first step. Or, if things get better very, very quickly, and it all drops out of the news, who knows, they will lose interest very quickly. But frankly, the industry is not going to drop out of the news, but that's not all the fault of the news and the legislators, that is the fault of certain practices in the industry.

MR. ANGLE: I guess that I would just add that Terry in his remarks noted the rather low level of real insight into the industry that he has found in Washington. Someone recently said to me that the people in Washington still believe that GAAP accounting is a more stringent accounting standard for life insurance than stat accounting, as apparently GAAP is in other regulated industries. If that's true, people in Washington really are starting at a fairly simple level of knowledge. The other thing I would say as a long distance observer is that more revenues don't seem to be kicking around Capitol Hill for expansions of insurance regulation than are available in most state capitals.

MR. ROBBINS: Let me just ask a question of the panel. Bill Carroll mentioned the concept of an NAIC SWAT team going into the state when the state asks for help. What are the duties and responsibilities of the new slot created for an NAIC actuary? What is that role?

MR. LENNON: I think, probably any of you who are familiar with the way the NAIC operates, know that there is an NAIC staff person attached to every working group, every committee and every task force, and they are responsible for keeping it kind of glued together and making sure that the meetings are arranged, and they go there very often to take notes. I think that the actuarial meetings are probably the most difficult for a staff person to take notes at, because it is a discipline that isn't shared, so I am sure part of it is just going to be to interface with all the actuarial activity that goes on at the NAIC. Beyond that, who knows? It might be the beginnings of taking care of the valuation actuary issue because I think that the NAIC has now adopted laws that do require some valuation actuary work. The fact is that they don't exist in many states. Eventually they may become available through an office

at the NAIC or something of that kind. I am not predicting that. I am just saying that's a possibility.

MR. ANTHONY J. ZEPPETELLA: I have been slightly involved with some of the industry subcommittees working on the risk-adjusted capital ratio. I should say that I come from a New York company whose only insurance subsidiary is a Florida company, so I have some bias in this, but I suggested at a session, and I won't say in what context it was phrased, that the C-4 risk should perhaps vary by the state of domicile. That is possibly something to consider, perhaps varying that by whether or not the state is accredited. It seems that the NAIC is trying to put pressure on such states in other ways anyway, so I throw it out to see if you have any suggestions.

MR. CARROLL: That's not a bad idea, and you probably find that the regulators are as sensitive to the C-4 risk as the industry seems to be.