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THE NAIC AND INSURANCE REGULATION

Leader: Walter S. Rugland
Speaker: Steven T. Foster*

MR. WALTER S. RUGLAND: We are very honored to have Steven T. Foster with us. Commissioner Foster is president of the NAIC. Since 1987, he has been Insurance Commissioner, State Corporation Commission, of the Commonwealth of Virginia. Before that he worked in local government as a county administrator in Virginia. Commissioner Foster holds a master's degree in public administration from the University of Virginia.

MR. STEPHEN T. FOSTER: I'm not the right insurance commissioner to speak to you. The NAIC has improved substantially, with the recent addition of our first life and health actuary. Robert Wilcox from Utah is a health and life actuary, and perhaps next year you might want to ask him to come, because he can probably speak your language more than I can. We are very glad to have an actuary among our ranks. A few years ago, we picked up our first CPA, the commissioner from Rhode Island. Those like me who are neither actuaries nor CPAs, nor former industry people (in fact, in my case, a former county manager), are always glad to see people come into office who have good expertise and background, because they can fill in many of the gaps that we certainly leave.

My being here on behalf of the NAIC is a strong testimony to the valued relationship that the NAIC believes it has with the Society of Actuaries, the Academy of Actuaries, and the Casualty Actuarial Society (CAS). We have come to realize more and more the essential part you play in the overall sphere of insurance regulation; you are a vital part of that process.

I'm reminded, looking out at this sea of actuaries, of something President Kennedy once said to a group of Nobel prize recipients. In this room, we have finally assembled a group of great minds, whose combined intellects certainly exceeds that of Thomas Jefferson. In case you don't know what President Kennedy said, he said to this group of Nobel prize recipients that perhaps in that room on that night, if you combined the intellects of all those people, you may have come close to the intellect of Thomas Jefferson dining alone in his home in Monticello. Certainly in this room, with the expertise and training and background all of you bring to your respective positions, I can hardly imagine a more impressive audience for me to talk with about these vital elements of insurance regulation.

The role of the actuary has become more and more critical as state regulators go about their business of trying to regulate for solvency. I was a bit taken by the button "Ask An Actuary." My experience as a regulator has been that it's never difficult to ask an actuary a question. What's more difficult is to understand the answer he or she gives.

* Mr. Foster, not a member of the sponsoring organizations, is President of the National Association of Insurance Commissioners and is Insurance Commissioner, State Corporation Commission, Commonwealth of Virginia.

I must say that I was impressed with the substance of the little card that goes with these buttons. I especially was taken with what I'll refer to as the second bullet on that card. It says that the actuarial profession has come of age; it is poised to take a leading role in keeping our businesses and financial systems strong. I commend the individual or committee that came up with that statement. That's a tremendous statement for your profession to make, and it gives me great comfort to know the extent to which you believe you are an integral part of this process of trying to maintain, in this case, the financial solvency of the insurance industry.

I've been an insurance regulator for more than six years. That's not very long by most standards, but as you may know, that's fairly long by insurance commissioner tenure standards. Most insurance commissioners remain in office about two or three years. In the last three weeks, four insurance commissioners have either left our ranks or made announcements that they will be departing. But as one whose been around for six years (just to give you some perspective, only about five insurance commissioners have been in their positions longer than six years), I think we have to be concerned about the extent to which insurance commissioners' positions turn too frequently. Frequent turnover can be a problem regarding effective state regulation, and there certainly are critics, included among them are some in Congress, who are quick to point this out. Of course, that lead to the revolving-door arguments; look at where they go after they leave their positions.

In Virginia, six years ago the role of the actuary, whether it was life, health, or property and casualty, was primarily the traditional role of looking at rates. Virginia is, for the most part, a competitive rating state. We're not prior approval in most lines, but in some we are, and we saw the traditional role of the consulting actuary. We don't have any staff actuaries. Since then, over the course of that same six years, we have seen actuaries become more intimately involved, primarily in the way we examine our domestic insurance industry with regard to financial solvency. Those same consulting actuaries are hired for practically every examination that we conduct of our domestic industry. We, like many states, also look at things other than insurance companies, such as group self-insurance associations for worker's compensation. Actuaries are looking at the extent to which these group self-insurance associations are adequately posting their reserves and to what extent reserves need to be increased. We play a vital role in deciding when those associations can pay dividends back to the employers.

Certainly in solvency regulation, we're seeing actuaries literally out in the field, working side by side with our financial examiners; this is something you did not see in Virginia six years ago, and my guess is this was not seen in the typical state. In the same way, we have become more concerned about the extent to which reinsurance contracts may not actually provide for a significant or substantial transfer of risk. Virginia was among the first group of states to enact changes in its statute that required the eventual burning off of surplus relief or financial reinsurance. People in my department can look at those contracts, but in the end, we have to have an actuary review those contracts. As many of you know, that's not a simple matter of quickly flipping through these contracts and deciding whether there is a substantial transfer of risk.

Insurance regulators have become more aware of the extent to which we've got to rely on the actuarial profession. I hope you're cranking out enough new actuaries to keep up with this new demand that you'll be seeing over time from state regulators, because it's important that we have your expertise, your background, and what you have to offer as part of the regulatory team, which includes our financial examiners and our financial analysts, those who go in and work on the computer systems and do the checks in that regard. You are now part of an integral process, and I see your role becoming more enhanced as time goes on. Certainly it won't be less.

The NAIC has embarked on a program of accreditation. In 1991, the NAIC set out in its procedures a threshold of effective solvency regulation that it thinks each state must achieve. That was a substantial step for a volunteer organization of 55 insurance commissioners to take. In our 140-year history, we had not had such standards. A state in the union or the District of Columbia, or one of the four U.S. territories, you could just join and be a member of the NAIC. This is not the case anymore. Virginia and most states have taken steps to go to their statutes, change the laws, and say for the first time that they will examine not just the domestic industry, but they will examine all licensed carriers in their states. In Virginia, the statute says that we may defer the financial examination to a home state but only if that home state, that domiciliary state, is in fact accredited by the NAIC. This results in a substantial change in the relationship among Virginia and the other states.

We had 19 states accredited. We hope to eventually have 50 states plus the District and the four territories. We reduced our ranks by one at the last NAIC meeting in March. We suspended the certification of New York. There are those in Congress who criticize our accreditation process, who are quick to comment that it looks like the NAIC is counting backward rather than counting forward, by going from 19 states to 18 states. Actually it's the reverse. It's an indication of how serious the NAIC takes this process, and if New York or any other state fails to put laws and regulations on its books in the legislature that we believe are essential to financial solvency regulation, that particular state or those states will risk their accreditation. So New York is temporarily off the list. This really doesn't have any effect until January 1, 1994, because that's when the NAIC process and the respective statutes in the given states will kick in with the wording. It says we'll examine all companies, but for those companies domiciled in the accredited state, we will defer to that state regulator's examination.

The NAIC is taking very seriously the process whereby we are enforcing this threshold of essential financial regulation of the insurance industry. Many have asked if we haven't done this in direct response to the threat of federal regulation. We began this process before there were actual bills to look at drafted by Representative Dingell or Representative Gonzalez, whichever bill you want to talk about this week, but certainly the impetus behind our movement to get states accredited was affected by the extent to which the U.S. Congress and members of that Congress are looking at how well we do our job in regard to regulating this insurance industry. I will not tell you that our accreditation process was not moved ahead somewhat by the federal regulation. If you were to take time to read that federal bill drafted by Representative Dingell's committee, you would see why we should have concerns about federal regulation.

The bill that they have put in the hopper now has been the subject of two hearings, one last week and one the week prior to that. Large insurers could opt to be federally certified. If they were federally certified, then the states would be preempted from solvency regulation. One curious note in the statute for those companies that choose to be federally certified is that the federal law required those companies to send a copy of their annual statements to each state in which they are licensed. If you're licensed in 50 states, you send out 50 copies. It sounds like they're giving some credence to state regulation. But if you keep reading, you'll get to the fine print that says the states can do nothing with those annual statements. The states cannot use those annual statements in any way to impede an insurer from continuing to write business in that particular state. As I testified last week to the congressional committee, they might as well save the postage. To send an annual statement to a state insurance department but say it can't be used, why waste the time?

There are other aspects of that federal bill that should be of concern, not only to company and to state regulators, but to policyholders. No one has yet convinced me that some system of dual regulation would be better than a system of state regulation, particularly when the federal regulation provides for fairly broad preemption of the states. Nobody knows how quickly the federal agency would be up and going. No one knows where they'll get their staff from, although some would suggest they'll get some of their staff from the states, and maybe soon you might be interested.

Right now there is no bureaucracy in Washington. We are told to trust and believe that this same federal government that gave us the S&L crisis will give us the same kind of regulation of the insurance industry. I realize there are those who may disagree with how I characterized that, but the point is, the NAIC has taken its steps to boost effective solvency regulations to the state level, partially as a result of this threat of federal regulation. I, for one, do not object to Congress asking the states to tell them about how well, or in some respects, how poorly, we regulate this industry. When you see, as we did two years ago, not one, but several large life insurers go into receivership, there was reason for the American public to be concerned.

There are those who watch the goings on in Washington and who say that Representative Dingell missed an opportunity for about six months. He had a window of opportunities, they call it, to get federal regulation on the books. What happened with those receiverships (and we had one in Virginia, that being Fidelity Bankers Life Insurance Company, a subsidiary of First Capital Holding), was that the states, for the most part, stepped in and took over these companies, and in the end, policyholders were for the most part protected. In our case, there is an assumption reinsurance agreement with the Hartford Life Insurance Company. In the end, we believe there will be no guaranteed fund assessment required in any state.

Still, the fact that there were many insolvencies, and that many went into receivership so quickly, had I been in Congress, I would have asked the same kind of questions. "States, give us some comfort up here that we should continue this arrangement under which we sort of flipped the typical federal system of government where the federal government is primary and the state is secondary." The McKerran Ferguson Act says the reverse, the federal government may only regulate insurance to the extent the states don't. So there is the reverse of the state department's regulator,

and the federal government for the most part doesn't regulate, because if they did, it could only regulate in those areas under current law in the states that don't regulate.

It's important for us to keep this in mind as we hear this debate of state versus federal regulations. Certainly there is great area for improvement among the states. We talk about some of the problems that companies and others face, with the inconsistency across state lines, the duplication, the extent to which form approval may be difficult in many states, or it's so unpredictable and takes so much time. These are all valid criticisms, in some sense, of the existing system, and I think the states can and should respond to those areas. We as insurance regulators believe that we have a duty to see that insurance markets are expanded, to see that product development is allowed, to see the introduction of new products in the marketplace. We don't benefit from being opposed to, or in some way contrary to, the development of new products.

As many of you know who get involved with filings, etc., the states have to look at these new products to make sure they conform with the requisite state laws and regulations. But we still recognize that there are obviously inefficiencies that exist in a system that has 50 different states looking at insurance products. All of us in this arena of insurance regulation, insurance solvency, know that our reputations are on the line, and you don't escape that same kind of scrutiny.

In the past six years, I have seen more focus given to the roles, obviously, of CPA firms, and in some respects, to the role of actuarial firms. You can say fairly or unfairly, that their reputations, with the problems with the S&Ls, in the public's mind and in the mind of policymakers, have been tarnished. I've heard some very severe congressional comments made about CPA firms during hearings. They tend just to take a broad brush and say, "Well look at the CPA firms and their role and this savings and loan and that savings and loan; if a CPA testifies, is he or she supposed to impress me, the congressman?"

You haven't gotten to that as actuaries, but my guess is you need to prepare yourself, because you may find yourself more under that kind of scrutiny more often. Let me just offer one example. In Virginia, we were looking at how we regulate credit accident and sickness insurance, and we had in place, prior to a year ago, a loss-ratio rate regulatory setup. We had companies and their actuaries certifying that the rates that were on file would produce or should produce a 50% loss ratio. We had reason to think that perhaps some of these filings were not in fact producing 50% loss ratios, so we went to the NAIC's database and pulled the companies' annual statement information. We had the companies verify this, but these same companies, whose actuarial certifications were such that we were supposed to think there would be a 50% loss ratio, were literally in the low teens. We saw them in the 20s and 30s, and only a handful were producing 50% loss ratios.

That gave rise to our changing the way in which we regulate rates in Virginia. We had a hard time understanding how actuarial certification would permit loss ratios at that level; not for a one-year period of time, but for a three- or four-year average period of time. I mention that, not to impugn all actuaries, but to give an example of how your role in what you do comes into the public policy arena, and here legislators were saying that's not a very effective system of rate regulation. They said to me,

"Commissioner Foster, if you're blindly accepting those actuarial certifications and you're getting that kind of result, you need to replace that loss-ratio regulation." We eventually ended up with a prima facie rate. That was the preference of some insurers, because we were trying to induce these insurers to refile their rates to reflect a 50% loss ratio and no insurer wanted to do it unless on that same day all their competitors did it. I was told, "Commissioner, we'd like to do that, but unless you can get the other 48 companies to do it the same day, we're not going to do it." You can imagine what we went through, because we typically don't deal with one company and say we'll deal with it at the same time we deal with others. We take it one company at a time.

I mention that as an indication of how you're being drawn into the public spotlight. Your role, whether you work for an insurance company, whether you're an independent, whether you work for a consulting firm, whether you work for a state, or wherever, your work and your role will come under increased scrutiny. Obviously, as the NAIC requires states to have actuarial certification, which we're doing as the state requires the companies to do it, it will bring you more into that spotlight. You should see that as a good thing, because I believe you're striving for this. You are recognized more and more as an integral player in the whole process, both on the company side and on the regulatory side, of insuring the solvency, stability, and long-term viability of the insurance industry. In the end, we'll probably have a stronger and more solvent insurance industry, to the extent all of us are under increased scrutiny and in the limelight.

Let me say that we are appreciative of the extent to which you've been involved actively in the NAIC matters. Many of you have spent time, either through the Academy or the Society, working with us on various products and on various things we do at the NAIC. Certainly one we hold as a prime example of what we're doing in regard to effective solvency regulation is the life and health risk-based capital formula. Almost every regulator without exception agrees that's a much better way for us to deal with the required surplus of insurers. We had direct actuarial support in that process by working with the staff of the states on that committee and with Terry Lennon and his group from New York. It is much appreciated. We the regulators, through the common nexus of the NAIC, can benefit from your expertise. There are great things that the NAIC can do more efficiently than the 50 states could ever hope to accomplish. There's room for us to look to the NAIC more in that regard, rather than to have 50 states trying to serve, if you will, as laboratories for change. Do it more and more through the NAIC. There will always be exceptions to that, because it is beneficial for states to be laboratories, and some states trying something first before maybe the majority of the states believe it's something that all states are ready for, and in that regard, we all learn from each other.

The same thing holds true to the extent you've been actively involved in working with our life and health actuarial task force over the course of the last two or three years in developing many models, both model acts and regulations that primarily deal with the small-employer health insurance market. As you know, the NAIC has a model act on that. We now have a model regulation. Many of you have been involved in those efforts, and we very much appreciate your input, and we are hopeful and trustful that that will continue. Most states have not sat back idly waiting for President and Mrs. Clinton, in their task force, to develop this new federal scheme in regard to health

care reform. So most states have been actively involved in trying to set up their own things in regard to small-employer reform. You've been very helpful in designing those model acts and writing your input.

I want to clarify one thing that perhaps needs some attention or some clarification: the recent action taken by the NAIC to terminate what we used to call advisory committees. The NAIC has gone through a process in the last four or five months of looking critically at how we are perceived by those whom we regulate and by the public affected by how we regulate. There were some perception problems that we were concerned about. One had to do with the extent to which there was direct industry funding of certain official events at the NAIC meeting. We've taken steps this year to curtail and eliminate that. Anything the NAIC does at its meetings will be paid for by the NAIC. Obviously, as you and I both know, many revenues derived by the NAIC come from registration fees paid by those who attend. Still there was a perception problem of the insurance commissioners going to a dinner paid for and sponsored by 20 nameless and faceless insurance executives in Boston or Chicago. We thought that perception problem was detracting from the job we were trying to do. Our response was to eliminate that funding.

On the issue of former advisory committees, and my guess is some of you have served in that capacity, by design they were supposed to sunset this year. In practice, they were not in most cases. Some of these advisory committees took on a life of their own. They were used by many people as a means to suggest that they were a direct adjunct to the NAIC. I saw a witness testify in Virginia with a long list of every advisory committee that the witness ever served on (without regard for whether it was a one-year project, a three-month project), and the indication was that the NAIC has this direct connection with those who regulate. There will be no formal advisory committees. There will be great encouragement given to the chairman of each of our task forces, working groups, and committees. They are required to pull together a group of experts whom we believe are important and vital to the development of whatever model act or regulation that we're developing. You will still see informal groups of people pulled together from the various areas of expertise that we think are appropriate to a given model act or model regulation. Some have suggested that is style over substance. My response to that is it's not, but we have to make sure the NAIC is open and deliberative and that we seek out the input not only of actuaries, but of companies and others who are affected by what we do. That is different from having formalized relationships in the eyes of the American public. It might give them some reason to believe, and again it's based on the perception that perhaps the regulator is not as detached as he or she should be from those who are regulated.

I want to encourage all of you who have been involved with the NAIC advisory committees in the past, whether it's the life and health actual task force or some of the areas dealing with small-employer insurance market reform, to continue to offer your services through either the Society or through the Academy. We very much value your input. We need to hear from you. We don't operate under the assumption that we draft perfect model regulations and acts. In fact, it's the opposite. We ask people to tell us what's wrong, and usually people do. For the most part, we get quick responses as to what people think is wrong, but it's important for us to have

that kind of relationship, and I would encourage all of you to be part of that process and to do all you can do.

I want to encourage all of you to continue your pursuits to maintain the high standards and integrity of your profession. I think for the most part, you enjoy a very good reputation. You're looked upon by those who understand what you do as people who properly and appropriately in some sense discipline and police your membership, whether it be the Society or the Academy. Keep up that effort, boast of that effort, and enhance that effort, because there is nothing more important in this world in what we're doing than our credibility. Whether it be actuaries, whether it be regulators, that is paramount and that's my own personal opinion. It's not an official NAIC position, although I would hope it would be.

We all must stand up to the scrutiny that will be given to this industry, to your industry, to your profession, and to the scrutiny given to how well the states regulate this industry. I want to encourage you to continue your efforts with continuing education, increasing your credentialing, and I want to encourage all of you to work with me, work with the NAIC, work with those insurance commissioners whom you may know, either because you're a consultant to them or because you happen to reside and work in a given state. We need your input. We relish it and without it, we will not do the kind of job we should do.

MR. JERRY F. ENOCH: With only 18 states accredited and with January 1, 1994 being the deadline for that implementation, is there any way that all the states will be accredited by the end of this year? What do you foresee the regulatory landscape looking like in 1994?

MR. FOSTER: I don't think we should set a yardstick, and I'm not suggesting you are, but some do. Say the yardstick of success is whether 50 states are accredited by December 31, 1993. We will probably see as many as 20 states go through our independent audit process, meaning we have a team of four or five people who don't work for the NAIC, but who go out and examine on site at the state department offices for about four or five days. Most of the states will be looked at during the second half of 1993. The reason is, most of our legislators are still in session or have just now adjourned, and when the NAIC looks at the actions on your books, one of the tests we apply is to what extent those laws are effective. So we'll see the vast majority of states that seek accreditation this year, asking for it during the latter half of this year.

Let's just say for a moment that we unsuspend New York during the course of the year, and let's just say we pick up enough to get to 35 states. What I have suggested to those who have asked is at that time, first look at the premium volume of the domestic industry of those 35 states. Let's just say you've got almost all the large states, and most of the medium-sized states. When I say large and medium, I mean as to domestic insurance premium. Let's say combined, 88% of the premium written in this country is written by companies domiciled in one of those 35 states. Certainly those 35 states can fill the void left and look at the other 12% of premium as our statutes all kick in. If you're a company that's in a state that's not accredited, you will find yourself subject to an examination some time after 1994. You may be examined by your home state, which let's just say is not accredited, but you will

probably find an examination being led by Virginia, New York, or some accredited state.

The real key is to look at the number of states accredited. What is the volume of their domestic industry? What is the volume of their industry generally? If we find that 95% of the premium in this country is being written by companies licensed in the 35 states, then I'm not that concerned about the other 15 states at the moment. I want those 15 states accredited. In the end that's our ultimate goal, but I don't think the programs would be unsuccessful if it's not met.

The second part of your question dealt with 1994. Much of that will be determined by what happens in Congress. If you ask those inside Washington, some will say that 1993 is not the year for federal regulation, that too much is on the plate with health care reform, budget deficits, and everything else. So 1994 could be the year we see some activity on the part of the federal government, obviously an extent to which that preempts the states. That could be a big part of 1994. It will be the first year that you will see states operating under the system of accreditation, where Virginia, for example, will give less and less attention and, in fact, perhaps no attention, to those foreign companies licensed in Virginia and that are domiciled in the accredited states. One of the benefits of this is that all states over time should be devoting substantially all of their resources to their own domestic industry. That's not saying there won't be some desk audits or a desk analysis given to foreign carriers, but it will be a direct inducement for us to focus back on our domestic companies, and I think in the end, everybody benefits from that.