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WISHFUL THINKING

A World View of Insurance Solvency Regulation

A REPORT

BY THE

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON ENERGY AND COMMERCE

U.S. HOUSE OF REPRESENTATIVES

TOGETHER WITH

MINORITY VIEWS

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U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE,
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS,
Washington, DC., October 19, 1994.

TO MEMBERS OF THE COMMITTEE ON ENERGY AND COMMERCE:

I am pleased to transmit to you a report by the Subcommittee on Oversight and Investigations entitled *Wishful Thinking: A World View of Insurance Solvency Regulation.* This report, a follow-up to the *Failed Promises* report issued in February 1990, sets forth the subcommittee's findings resulting from its 6-year investigation into the causes of insurance company failures. *Wishful Thinking* analyzes formal testimony from nine additional subcommittee hearings held during the past 4 years, as well as many interviews and document reviews conducted by the subcommittee staff and the General Accounting Office. Both *Failed Promises* and *Wishful Thinking* describe the existing State regulatory system as dangerously inadequate for supervising the solvency of a $2.3 trillion financial industry which depends substantially on offshore companies to pay its claims to customers.

This report is timely because many of the issues it covers are presently being considered by Congress and State legislatures. State insurance commissions and industry trade groups are also considering changes in regulatory rules and methods to address several of these issues. A lack of solid information and analysis regarding the causes of solvency problems and the enormous impact of foreign-based insurers on the U.S. marketplace has seriously hampered these policymaking efforts. The subcommittee's factual findings and conclusions in *Wishful Thinking* provide the missing information needed to complete national solvency reforms successfully.

Currently, insurance companies in the United States are licensed and regulated separately by each of the 50 States, with no involvement or supervision by the Federal Government. State governments, however, do not have sufficient resources, legal powers, or resolve to protect policyholders from mismanagement and fraud practiced at some insurance companies here and abroad. As noted by the report's *Wishful Thinking* title, State insurance supervision

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in this country is too often founded on programs that simply hope for the best, because they are not equipped to avert the worst. Such regulatory weaknesses have led to a disturbing growth in highly-publicized and expensive failures of life, health, and property/casualty insurers, unfairly denying and delaying payments to innocent victims who rely upon insurance coverage for financial security.

The subcommittee reaches several fundamental conclusions in *Wishful Thinking* crucial to guiding the reform work of Congress, State legislatures, and State insurance commissions:

(1) Rascality, speculative excess, and management incompetence continue to burden the insurance industry in the 1990's. This will always be the case as long as easy money moves faster than common sense and prudence.

(2) Insurance regulation in the United States and worldwide is a supervisory Babel, marked by strongly divergent attitudes, laws, accounting rules, resources, languages, and cultures. All of these factors have combined to create an environment of local self-interest that does not foster regulatory communication and cooperation.

(3) Unlike the fragmented regulatory system, insurance company operations reach across the country and around the globe to form a closely interwoven network that responds to money and markets, rather than political boundaries. Unhappily, this network is vulnerable to abuse and manipulation.

(4) The United States is the Nation most harmed by regulatory neglect and confusion because it is the world's largest insurance market, relying to a great degree on foreign capacity, and the responsibility for protecting its citizens is spread haphazardly among 50 States and a passel of alien governments.

(5) Without Federal assistance, present solvency programs sponsored by State regulators and the National Association of Insurance Commissioners (NAIC) are doomed to inadequacy because they lack the necessary authority and resources.

(6) Insurance regulators everywhere need to give far more attention to hands-on monitoring and enforcement of their solvency rules, instead of presuming they are being obeyed. In addition, regulators must change their priorities to more actively search for the people and companies that are breaking the rules.

The subcommittee's conclusions point the way to a dependable insurance regulatory system in the United States. Our mission has been to evaluate present circumstances, so that the Committee on Energy and Commerce can craft an effective national solvency program that recognizes the Federal Government's responsibility to plug the gaps in State supervision. The savings and loan debacle clearly demonstrates what can happen when Congress fails to insist that Federal and State regulators properly police the solvency of institutions which hold the public's money and trust.

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From its inception, the subcommittee's insurance investigation was supported by both Democratic and Republican members who understood the need to act before a crisis strikes. This common desire to analyze and heed the growing danger of major insurance company failures led to a unanimous subcommittee vote to issue the *Failed Promises* report in 1990. Regrettably, the Republican members of the subcommittee did not join the majority in voting to support the final version of *Wishful Thinking*. They believe the report's call for strong Federal action implies overbearing regulation that will be deemed a "panacea." Conversely, the Democratic members read the plain language of the report to recommend a Federal partnership with State regulators and private industry.

The most important fact is that all subcommittee members have endorsed the factual findings of *Wishful Thinking*, as well as appropriate Federal involvement to accomplish the key goals of uniform standards, meaningful enforcement, and controlling alien insurers and reinsurers. Current disagreements in Congress over how best to achieve these goals mirror the different views expressed among State regulators, industry participants, and consumers. Different viewpoints about proposed solutions, however, should not overshadow the subcommittee's unified recognition of existing problems, or its resolve to correct them. That would indeed be the ultimate exercise in wishful thinking.

The Committee on Energy and Commerce had inadequate jurisdiction to control the financial regulators who permitted the savings and loan disaster, but assuring the safety and soundness of insurance companies operating in interstate and foreign commerce lies squarely within our area of responsibility. The American public expects us to exercise our legislative powers to protect them, and issuing *Wishful Thinking* is another substantial step in providing leadership to avoid foreseeable financial problems in the insurance industry. While our vigorous oversight activities continue, I look forward to working closely with all committee members as we develop legislation to implement the subcommittee's recommendations. The United States cannot afford to trifle with the soundness of an industry which, from health insurance to retirement benefits, and from homeowner's coverage to corporate liability insurance, exists to furnish financial security for all our citizens.

Sincerely,

JOHN D. DINGELL, *Chairman*.

Enclosure.

WISHFUL THINKING

A World View of Insurance Solvency Regulation

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wish' ful think' ing. *Interpretation of facts or actions as one would like them to be rather than as they really are.*

Random House Dictionary.

wishful thinking. *Erroneous identification of one's own wishes with reality.*

American Heritage Dictionary
of the English Language.

Four years ago, the Subcommittee on Oversight and Investigations issued a unanimous report which described how an increasing number of costly company failures were threatening public confidence in the soundness of the insurance industry. That report detailed serious weaknesses in the present system for regulating insurance in the United States, and questioned the ability and commitment of State regulators to handle solvency problems. It also warned that a financial debacle similar to the one which engulfed the savings and loan industry could erupt if such problems were not promptly addressed. To succinctly convey its findings and concerns, the subcommittee named its report *Failed Promises.* [1]

The *Failed Promises* title highlighted the basic nature and risk of an insurance policy: Customers pay premiums in advance to companies which, in return, promise to pay future cash benefits when losses covered by the policy contract occur. If an insurer is unable to meet its promise of future payments to policyholders, there is a complete failure of the financial bond and sense of trust that have made insurance coverage an economic and legal requirement of modern life.

The subcommittee chose *Wishful Thinking* as the title phrase which best expresses the findings of this report. While *Failed Promises* was a look back to analyze how solvency problems had become a serious threat, the purpose of this report is to assess the responses of the State and foreign regulatory agencies which license and supervise the business affairs of insurers operating in the United States. *Wishful Thinking* imparts the subcommittee's basic conclusion that, regrettably, most authorities are regulating solvency with a pronounced disregard for the known causes of insurer failures, as well as a blind eye to human behavior and experience.

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[1] *Failed Promises*, Insurance Company Insolvencies, Committee Print 101–P. Issued in February 1990.

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PART I

SUMMARY AND FINDINGS

Preventing insolvencies was the original purpose for regulating insurers. In the late nineteenth century, widespread commercial development of companies selling financial protection against catastrophic losses brought a corresponding need for State governments to monitor the fiscal stewardship of those companies. State insurance commissions changed their focus over the years as the public demanded governmental protection from unfair insurance rates and marketing practices, and that shift led to de-emphasizing solvency as the primary goal in regulating the conduct of insurance providers.

Until the 1980's, a long period of relative financial stability had lulled customers, industry participants, and regulators alike into casually accepting solvency as a certainty for any State-licensed insurer operating confidently in the marketplace. This attitude was rapidly dispelled by a series of costly and highly-publicized company failures, which left several billion dollars in unpaid claims to be borne by the public and healthy insurers through uncovered losses, delayed payments, guarantee fund assessments, and higher taxes. People wondered why the regulatory system was allowing insurance companies to fail abruptly, without making the claims payments that were widely assumed to be guaranteed by government supervision and control. As a result, solvency issues have regained their earlier prominence as matters that must receive the active attention of regulators.

The subcommittee explored newfound concerns about the safety of insurance licensing and supervision in *Failed Promises* and nine subsequent public hearings. After conducting its own investigations and listening to State government officials, the National Association of Insurance Commissioners, industry participants, and the General Accounting Office, the subcommittee concludes that solvency regulation in the United States is based in many ways on wishful thinking. The record shows that responsible authorities are instituting rules and procedures whose main effect will be to guard the financial condition of insurers that are willing to comply with them. This approach does not heed the facts of actual insolvencies, which are typically characterized by a flagrant disregard for insurance laws, sound business standards, and honest reporting to regulators.

Misdirected supervision is very troubling because insurance industry mischief still occurs in the 1990's. Although the outright freebooters make fascinating reading, they are just the most visible symptoms of a much larger solvency threat presented by mainstream opportunists selling themselves and their products as too

clever to be matched by prosaic competitors. These marauders include the takeover specialists who use accounting gimmicks to create impressive paper profits from combining otherwise unimpressive companies, as well as the insurance companies which continue to rent their licenses to uncontrolled managing general agents in exchange for generous earnings that are obviously suspect. In addition, there remains a constant erosion of industry financial strength attributable to the plodding incompetence of certain management officials who are noticeably unfit for the positions of responsibility they occupy.

The subcommittee concluded its *Failed Promises* report by posing a series of questions about the ability and commitment of State regulators to correct solvency problems. Those questions focused on areas where the subcommittee's hearings and investigations had revealed serious weaknesses in the present regulatory system, including insurer licensing and monitoring, capitalization requirements, reinsurance arrangements, financial reporting, affiliated company transactions, agent relationships, and enforcement activities. By clarifying what specific actions must be taken and who is responsible for taking them, the subcommittee sought to determine the directions which should be taken to improve insurance supervision in the United States.

Since *Failed Promises* was issued, substantial information has been developed to provide suitable guidance in every important area where solvency reforms are required. Tough policy decisions must still be made, but they can be addressed today on the basis of real knowledge rather than speculation or prejudice.

THE ESSENTIAL GOALS OF SOLVENCY REGULATION

The myriad issues involved in constructing a sound regulatory system can be condensed into a couple of fundamental truths. The most basic one is that *prevention* is the primary purpose of solvency regulation, and the only good way to measure its success. Few benefits accrue to policyholders and the public from monitoring the health of an insurance company that is already bankrupt. Insurance regulators may expect that some insolvencies will inevitably occur, but the facts show that company failures typically coincide with regulatory system failures.

From a supervisory perspective, prevention of harm to the public means employing an attitude and procedures that can realistically be expected to curtail the incipient operating and financial problems which typically grow into massive insolvencies. Sound standards and reporting requirements are the foundations of effective prevention programs, but routine checks on individual insurers are essential to catch both inadvertent and intentional departures from regulatory directives and accepted business practices. Ultimately, a good prevention program involves courage and commitment by regulators to take action before a deteriorating situation escalates beyond control.

The costs of effective solvency monitoring, like all safety precautions, must be measured against the costs of the insolvencies that would otherwise occur. Angry reactions to expensive and aggravating company failures are a direct incentive for raising the level of regulatory scrutiny likely to prevent them. Conversely, an

ineffectual approach to checking the financial condition of insurers indicates a willingness to suffer the costly effects of unpaid claims, guarantee fund assessments, administrative hassles, decades-long liquidation proceedings, and public fear.

Insurance regulators must also find the *means* to achieve their goals. A system committed to paying the costs of reliable prevention methods cannot succeed without the commensurate ability to perform the necessary tasks. Thus, a realistic formula for solvency regulation must encompass a focus on prevention, a commitment to bearing the related costs, and possession of the means needed to accomplish the steps which prevention entails.

Volumes of testimony, official reports, and investigative files point to three areas where this formula for sound regulation should be applied. Each of these is crucial for providing reasonable assurance that the quality of insurance products sold in interstate commerce in the United States will meet legitimate public expectations. Correcting the problems in these three areas will ameliorate the other regulatory deficiencies noted by the subcommittee.

(1) National Solvency Standards: Uniform standards are necessary to establish level conditions for buyers, sellers, and claimants across the country. Otherwise, the threat of interstate problems caused by insurers domiciled in weak regulatory jurisdictions will remain. The subcommittee received many complaints over the years from people who found themselves denied payment for legitimate claims. They discovered after an insolvency occurred that they fell between the cracks of different State protective schemes. Due to the confusing array of insurance company names and complicated corporate relationships, policyholders usually are not aware of the varying State supervision responsibilities, or gaps in guarantee fund coverage that apply to specific insurers. Complaints have also come from insurance companies that oppose the extra costs, time, and inconvenience required to satisfy State solvency standards which are needlessly different and redundant.

(2) Meaningful Enforcement: Enforcement of solvency standards, and the corresponding legal penalties for violating them, is the weakest link in the fragmented system of State regulation. Most insurance commissions do not adequately monitor the financial condition of insurers, and they typically use ineffective administrative sanctions against the few offenders who are detected. There has been little criminal law enforcement by State authorities against insurance industry culprits, even though every case observed by the subcommittee involved multiple infractions of the State insurance codes and fraud statutes which are already on the books. Federal criminal law enforcement is currently the only useful means for investigating and punishing actual crooks, but it has been too infrequently available to serve as a real deterrent for routine solvency abuses which are not obvious Federal violations. To strengthen this deterrent, Congress recently enacted new statutory provisions which broaden the definition of fraud, and specify that fraudulently operating an insurance company is a separate Federal crime.[2]

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[2] The Violent Crime Control and Law Enforcement Act of 1994, Section 320603, Public Law 103–322, September 13, 1994.

(3) Controlling Alien Insurers And Reinsurers: There must be adequate standards, review procedures, and controls for all foreign insurers and reinsurers choosing to do business with policyholders in the United States. Every nation has jurisdiction to regulate solvency matters in its domestic market, but the United States is alone in liberally granting access to unlicensed foreign companies. This open-door policy has created vexing difficulties for State regulators because a substantial portion of American commercial policies is placed overseas.

Significant improvements in financial supervision have been made during the past few years. The thrust of those advances, however, has been in creating new rule-based programs seemingly designed for an ideal world where every company follows the prescribed standards. They have not adequately addressed the need for substantial hands-on involvement by regulators to assure that all insurers will comply with the improved rules. In selecting *Wishful Thinking* as the title and major theme of this report, the subcommittee does not mean to denigrate present efforts to achieve solvency reforms, but to re-evaluate them in light of the factual record and public needs.

THE PRESENT SYSTEM: HERE, THERE, AND EVERYWHERE

The goal of preventing insolvencies is very unlikely to be achieved through the present regulatory apparatus. The fates of policyholders and claimants in the United States are spread among 50 autonomous State insurance commissions and a multitude of foreign regulatory agencies that operate for the individual benefit of the political systems which sponsor them. Insurance supervision is uncoordinated under the best conditions, and the slightest bit of chicanery or routine business complications can seriously upset the regulatory process.

The disarray begins in the United States. Although the Federal Government has sole authority to regulate interstate commerce matters affecting insurance, this power has not been used. Congress specifically deferred to the regulatory authority of State governments by statute almost 50 years ago. With no Federally-mandated government agency to coordinate their activities, State insurance commissions exercise their supervisory authority as separate and equal sovereign entities.

The States, individually or jointly, do not have adequate legal authority to regulate the insurance industry effectively. For example, they lack the power to overrule conflicting State standards and practices, and to negotiate cooperative agreements with foreign regulatory agencies. Consequently, State insurance commissions have been left to face worldwide regulatory challenges with only the insufficient tools and resources consigned to them by State legislatures. This mismatch between global responsibilities and local authority has caused frustration in good regulatory States and lack of effort in the weaker States.

Absence of a Federal involvement has not obviated the need for national guidance and coordination on solvency matters. Because nothing else is available, the States have attempted to fill the void through the National Association of Insurance Commissioners

(NAIC), a voluntary membership association comprised of insurance supervisors from each of the United States and its territories. Retaining their complete sovereignty, insurance supervisors come together at the NAIC to agree on the issues where 50 commissions can find harmony, and ignore or disagree on the rest. The NAIC and State insurance commissions have neither the authority nor the means to handle relations with foreign nations, yet offshore insurers and reinsurers without American operating licenses now hold approximately 40 percent of the commercial market in this country.

The safety of consumers in the United States is thus left to be guarded by a regulatory trade association and a fragmented group of largely ill-equipped State agencies. Overseas, the situation is even worse for Americans. Approximately 80 countries serve as the legal domicile and home base for insurance companies doing business in the United States. These countries include all the major trading nations of Europe and Asia, a bevy of island states concentrated in the Caribbean, and a sprinkling of commercial-center aspirants scattered around the globe. All of them grant licenses to insurance companies, and some of those licenses specify that the companies can only sell insurance to people who live elsewhere.

The subcommittee made a particular effort to measure the capabilities of the supervisory agencies in other countries. Information was gathered from regulatory reports filed with the NAIC, and a special questionnaire was sent directly to 47 of the nations identified as being significant providers of reinsurance for companies in the United States.

In addition, the General Accounting Office was asked to conduct a detailed analysis of the new deregulation scheme being implemented in the European Union. Foreign regulatory attitudes were found to cover the spectrum of possibilities, from doing nothing to having strict governmental controls over an insurer's business activities. Here are a few examples of the variations observed by the subcommittee:

- The supervisory attitudes in 10 countries can best be characterized by their failure to answer official correspondence from the subcommittee asking about their supervisory attitudes.
- Seven of the polled countries do not regulate reinsurance companies at all.
- To entice absentee investors, several islands promote special export insurance licenses, featuring self-regulation and absolute secrecy about finances and ownership.
- Japanese insurers are generally considered to be financially strong, but Japan's insurance agency, a subsidiary of the Banking and Finance Ministry, has no authority to investigate holding companies, and is bound by tough secrecy laws that prevent adequate public disclosures.
- The 12 European Union nations are just starting to implement multi-state cooperative solvency regulation similar to the system in the United States, with the attendant benefits and challenges.
- Lloyd's of London, the world's most famous insurance market, was delegated authority to regulate itself by the British government long ago. In recent years, however, the organization has experienced debilitating losses which have threatened its existence.

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Although foreign governments are not keen to discuss insurance company failures, the subcommittee found that most of the biggest insolvencies here were linked to distant lands. The unprincipled opportunism and greed practiced by wrongdoers in the United States was mirrored and abetted by their compatriots overseas. Moreover, there are distinct signs that such abuses occurred partly as a result of wishful regulatory practices in major commercial nations committed to guarding insurer solvency. In other countries, where solvency is given short shrift, the supervisory agencies implicitly assisted unsavory acts through intentional disregard for preventing or punishing them.

For policymakers in the United States, the subcommittee's survey of domestic and foreign regulatory practices presents a clear six-part message: (1) The insurance regulatory process is conducted by a large number of autonomous units spread across the country and around the world; (2) Insurance supervisors focus their resources on evaluating the paper trail of reports filed by insurers, an especially dubious practice in foreign jurisdictions with weak reporting requirements; (3) Communications and coordination among regulatory agencies are haphazard at best, and are often impossible; (4) Insurance regulation by different States and countries is not a coherent system, where standardized practices yield common results; (5) Fixing solvency weaknesses in the United States means dealing with foreign regulatory weaknesses; and (6) Protecting American consumers is not a priority of solvency regulation in other countries. Sound policymaking to correct known problems will require suitable measures to compensate for these structural gaps and flaws.

The single, overriding weakness plaguing the supervision of domestic and foreign insurance companies is the widespread practice of wishful thinking by regulatory officials. Although not normally a disparaging term, wishful thinking accurately describes a well-known human tendency to believe the unbelievable in order to avoid unpleasant realities. This concept is completely at odds with public expectations of solvency regulation as a tough, independent inspection intended to prevent foolishness and fraudulent behavior by insurers. How, then, has wishful thinking become such a pervasive attitude when it contradicts the basic purpose of regulation?

WISHFUL THINKING IN ACTION

Normal confusion in the regulatory network is greatly aggravated by the naive and overly idealistic attitudes displayed by many of its participants. Rather than an isolated instance here and there, these attitudes have actually become the foundations of major solvency programs which are supposed to protect the public in the United States and elsewhere. Although most State and foreign insurance regulators are well-intentioned, their assumptions and methodologies must be questioned in view of the factual record and common sense. The following are examples of the misdirected institutional attitudes that concern the subcommittee.

(1) Weaknesses in solvency regulation can be corrected by making better rules.

For regulators, rule-making offers the attraction of a controlled environment where solvency issues can be managed and resolved successfully using familiar methods. The difficulties associated with implementing tough, hands-on monitoring and enforcement mechanisms can be averted, if one believes that simply changing the rules fixes regulatory weaknesses. Furthermore, supervisors can comfortably explain bankrupt insurers, management improprieties, and other real world bogeys as statistical aberrations from the correct industry standards set forth in their manuals.

The problems documented by the subcommittee are not quite so straightforward as the standards set forth in the rulebooks. Normally, financial calamities are caused by gross mismanagement, fiduciary breaches, and fraudulent behavior, all of which happen in spite of the rules intended to prevent them. The people who commit these acts are little bothered by insurance laws and regulations, and have little trouble ignoring them. This pattern of neglect holds true whether the culprit was Carlos Miro hoodwinking the State regulatory system, Transit Casualty dispensing its pen freely to commission agents, Executive Life gambling its policyholders' security, or London market lemmings following one another over a financial precipice in pursuit of fool's gold.

(2) Solvency will be protected by focusing regulatory efforts on primary insurers.

Very few regulators actively supervise an insurance company's transactions with managing general agents, reinsurers, brokers, management companies, affiliates, and holding companies, yet those are the areas where fatal problems have always developed. Nonetheless, regulators persist in believing they can properly scrutinize an insurer's condition by confining their inquiry to matters shown on the company's books. Regulating on the faulty premise that an insurance company's fate is completely separate from its producers, affiliates, and reinsurers represents wishful thinking at its worst. Arranging insurance is often a chain transaction involving several participants, and checking the links proven to be the weakest should be the first priority of responsible supervision.

(3) Uniform solvency protection can be achieved by having different regulatory agencies apply the same standards.

The two leading groups trying to apply common standards to multiple regulatory agencies are the NAIC and the European Union. Neither of them has been able to establish a comprehensive set of mutually-recognized solvency standards among their member States, although both organizations have made progress in this difficult area. More importantly, there are significant variations in the way their commonly-accepted standards are actually implemented, based on the resources and methods employed by each regulatory agency. These differences among insurance supervisors are important because

the United States and Europe depend on coordinated multistate regulation to control problem companies.

Experience shows that weak insurance companies find the weakest regulators, and competition to attract business development and jobs has worked against uniformly sound enforcement of common standards. The fundamental difference between establishing uniform standards and uniformly applying those standards has caused tension and distrust among regulators who believe that some of their counterparts in other States are not doing an adequate job. That situation appears to be a continuing problem with multistate regulation, and its effect must be considered in constructing sensible programs.

(4) A domiciliary regulator will monitor an insurer's business wherever it operates.

Extraterritorial regulation is an essential element of viable multistate regulation, but it has proved unworkable in cases studied by the subcommittee. Many times, regulatory negligence results from the false belief that someone else will do the regulator's job by asking the right questions and making the right decisions. In practice, there is little incentive for an insurer's home-State supervisor to spend time and money looking beyond its own borders, particularly when the regulator is confident that domestic policyholders and claimants are adequately protected. Extraterritorial activities of an insurance company are also more easily hidden from a domestic regulator. Even when there is a real desire to obtain information on out-of-State transactions, there can be legal obstacles for regulators in gaining access to the right documents and people.

In the United States, any State granting an insurance license can theoretically examine the licensee's business, but attitudes and resource limitations normally dictate that a company's home State carry the burden for monitoring solvency. Going further, the European Union has formally adopted sole regulation by domiciliary States as the basis of its single-license passport system, and other member State supervisors are generally prohibited from interfering.

(5) Regulators will share important information regarding solvency and enforcement matters.

The only information that regulators openly share with each other is information which is already available to the public. This situation is further exacerbated by the fact that many foreign countries do not collect or publicly disclose important financial, operating, and ownership information needed to monitor an insurer's solvency. Where such information is disclosed, it is often misleading or incomplete for companies with solvency problems, because truthful reporting could induce other regulatory agencies to take preventive actions in order to protect their citizens.

In addition, legal prohibitions and liability fears among regulatory officials virtually eliminate exchanges of confidential information, especially when it relates to enforcement actions. Thus, the information which would be most useful in directing attention to problem areas is also the most likely not to be

shared with other regulators. In the absence of formally protected communications, some regulators have resorted to an informal system of winks, nods, and off-record comments to signal problems among themselves. This ad hoc approach is totally unsuitable as the basis for international regulatory communications.

(6) When insolvency threatens, regulators will cooperate to protect the interests of all parties.

Full cooperation among regulatory agencies facing a multi-state insolvency is unrealistic. Regulators are legally required as government officials to maximize recovered assets on behalf of their own citizens, and they could be personally liable if they failed to do so. Moreover, they fear sharing information and taking unified action because these steps could lead to a public run on an insurer, causing insolvency and diminished assets.

The failure of Executive Life Insurance Co. illustrates how jurisdictional self-interest supersedes the larger community interests when multi-state insolvencies arise. Other factors working against cooperation include embarrassment, political pressures, and the natural reluctance of regulators to accept blame for insolvencies. These regulatory system weaknesses will not vanish by simply acting as if they do not exist.

The subcommittee has been impressed with the quality of most regulatory personnel who are responsible for administering solvency programs, which makes it all the more disappointing that program designs are not as good as the people who must implement them. A realistic approach should drop unwise reliance on noble behavior, and instead emphasize systematic procedures that include background investigations, information verification, and thorough inquiries into significant business transactions and relationships. There is no magic to implementing a practical solvency program, but success does require tenacity, creativity, and the courage to insist upon the truth behind rosy promises made by insurers.

The factual record shows that renegade managers are unwilling to cooperate with the good intentions of supervisory officials. Until they were ultimately exposed, or fell under their own weight, the insurance company failures examined by the subcommittee were all vigorously and aggressively defended by their supporters as smart business ventures. None of these reprehensible cases was discovered or discouraged due to wishful regulatory attitudes about management honesty and prudence.

THE NAIC'S INHERENT LIMITATIONS

The National Association of Insurance Commissioners (NAIC) has promoted the collective interests of State insurance commissions for more than a century. It is a worthy organization with an impressive record of accomplishments in debating important issues, developing model laws, collecting financial information, and arranging regular meetings where State regulators can get to know one another and exchange ideas. Unfortunately, these substantial accomplishments have been overshadowed in recent years by ef-

forts to expand the NAIC into regulatory functions which it cannot perform.

Under the present State regulatory system, the NAIC is the only forum for attempting to develop adequate and uniform solvency standards throughout the United States. The group's efforts, however, are inevitably limited to advisory guidelines because it has no enforcement powers. Its decision-making is further constrained by a desire for consensus among its members, as well as the need to encourage voluntary implementation of its rules.

Lacking any power to mandate real changes in the way State insurance commissions perform their daily tasks, the NAIC has become a convenient rallying point for those who wish to make solvency reforms through concentrating on better rules. The organization is a natural choice for this mission because processing new standards and issuing manuals have been its traditional duties. Although it has flaws as a regulatory vehicle, the NAIC fulfills a useful role as a surrogate for State officials who want to do something to improve national solvency regulation, but have no other avenues which would be more effective in controlling events beyond their own borders.

The NAIC's solvency agenda began in earnest in 1988, with the creation of a package of model laws and regulations deemed to be the minimums necessary for any State insurance commission to be effective. In 1990, the organization moved into a regulatory stance by establishing its Financial Regulation Standards and Accreditation Program to certify which State commissions were complying with its package of minimum requirements. About the same time, the NAIC started a computer database to track potential wrongdoing, and substantially increased its capabilities to offer centralized financial analyses of national and alien insurance companies. Some of these steps are useful, but they have so far been ineffectual as an overall program to remedy underlying solvency problems.

The subcommittee has monitored since inception the NAIC's endeavors to assume the mantle of insurance solvency policeman on behalf of the United States. The group has expended enormous financial and political resources, yet so far its accreditation program has yielded controversy and limited results because the NAIC strayed into areas where it cannot achieve the promises made to its members and the public. Furthermore, State legislators have accused the NAIC of overreaching its authority as a private trade association by dictating what laws must be enacted.

Although there is an obvious need for national regulatory and enforcement actions to implement effective solvency regulation, the NAIC is simply the wrong entity to accomplish these goals. Despite its good intentions, the group has no more legal authority to regulate solvency than the Kiwanis Club, the Lions Club, the Jaycees, or any other public-spirited organization. Knowledgeable people in the regulatory and business communities understand the NAIC's innate limitations, but there remains strong pressure to make the group into something it is not because no other organization is available to regulate national solvency matters.

STATE REGULATION: TOO MANY COOKS WITHOUT A RECIPE

Unlike the NAIC, State insurance commissions are government agencies that can exercise real power to achieve their directives. The quality of State regulation reflects the diversity of the 50 political systems which generate it. Some States have sufficient leadership, resources, and public support to establish and monitor high solvency standards, while many others apparently depend on stronger States or the NAIC to protect their residents from troubled insurers. Each State maintains a separate regulatory apparatus with a full complement of rules, reports, and enforcement tools to protect its citizens, but differences among them have led to jurisdictional loopholes inviting abuse from wrongdoers and fast operators seeking the weakest regulator. Conflicting requirements have also meant costly and redundant licensing and supervisory procedures for well-managed companies, without demonstrably improving the overall quality of regulation.

Critics have long charged that State regulators are preoccupied with minutiae at the expense of seeing larger trends and events at regulated insurance companies. They argue that scarce resources are wasted on an obsession with overly detailed rules, misdirected financial examinations, and excessive licensing requirements that blanket all companies, while fundamental high-risk business shifts by certain companies into predatory marketing, junk bonds, fronting arrangements, and exotic reinsurance are neither questioned nor stopped.

Vigilant States and reputable insurance companies pay a steep price when their less able counterparts rely on unreal expectations. Not only must good regulators spend time and money to guard against insolvencies within their jurisdictions, they must also police the activities of companies based in other States, or run the risk of their residents being hurt by negligent supervision elsewhere. Substantial guarantee fund payments to State residents in expensive multi-state failures such as Mission Insurance Co. and Transit Casualty Co. have greatly added to these costs.

After 5 years of investigation, the subcommittee has concluded that current State supervision in the United States is lacking in the key areas needed to achieve national solvency regulation. The major reasons are limited legal authority, inadequate resources, and poor coordination. Despite rhetoric about the "State regulatory system," it is quite obvious that insurance commissions do not work together jointly as a national system. The 50 independent commissions, which operate at the behest of their respective State governments, clearly have different capabilities and interests in many areas. Commonly applied standards and coordinated multi-state enforcement have eluded them, and are not feasible when their allegiance and attention are naturally focused on home-State concerns.

Similarly, the quest for information and control over unlicensed alien insurers and reinsurers has been thwarted by the inability of State governments to enforce their requirements. Foreign companies operate freely across State lines through a fluid network of brokers, and belated State administrative orders prohibiting them

from future violations are the only potential retribution they face for wrongful behavior. These orders pose no threat to people living in other countries, who can bank the funds already in hand, and switch into new ventures not covered by prior State decrees.

Some State regulators also seem too willing to accept the burgeoning public costs associated with failed insurers. This tolerance for company failures may be encouraged by the existence of insolvency guarantee funds that act as a safety net to cushion the harmful effects of regulatory inaction or ineptitude. However, tolerant attitudes reduce the incentive for preventing insolvencies, and weaken the sense of urgency which drives major improvements in licensing and examination procedures.

Finally, State commissions do not possess the means to regulate the solvency of insurance companies operating across the United States and around the world. In addition to enormous practical hurdles, the legal limits on State authority are rooted absolutely in the United States Constitution. Some State commissioners have confronted the reality of their jurisdictional and resource limitations by asking the Federal Government to help, and even the NAIC has admitted the need for additional Federal legal authority to prosecute wrongdoers and control unlicensed foreign companies.

WHAT MUST BE DONE

Ironically, the present regulatory apparatus developed by the NAIC and State insurance commissions works best for those who need it the least. By emphasizing stricter standards, current solvency programs are destined to have their primary impact on insurers that are willing to obey the new rules without being compelled by regulatory authorities. The more mundane chores associated with routine monitoring and enforcement of existing requirements have not been properly addressed, so the people prone to abusing prudence and sound management are not likely to be caught before causing great harm. The only way to discover the dreamers, schemers, and renegades infecting the industry is to look for them. They rarely report their shenanigans voluntarily.

The solvency weaknesses identified by the subcommittee can be corrected, but forceful action will be required on a number of different fronts. For example, the NAIC and State commissions must re-direct their efforts toward resolving the matters already within their control under the existing regulatory framework. There are also important quality assurance measures that should be taken by insurance industry participants in the United States and overseas. New laws are not needed to reap the benefits of these improvements.

While much can be accomplished by using the means which are presently available to regulators and private industry, the Federal Government must accept its responsibility for performing the interstate and international functions which are beyond the powers of State governments. This will require additional legislation by Congress to establish the necessary supervisory and enforcement mechanisms, and to remove conflicting State requirements.

The subcommittee recognizes there is no single solution to the problems it has observed, and that no government or private sector organization can single-handedly implement all the changes which

are required. Accordingly, the subcommittee makes the following recommendations for each group which plays an important role in correcting solvency weaknesses.

(1) The National Association of Insurance Commissioners. As a forum for developing better standards, the NAIC is a useful channel for tapping the expertise of State regulatory officials seeking solutions to common problems. However, the organization's solvency accreditation program, though well-intended, will not succeed as a substitute for appropriate governmental action. The NAIC relies on the voluntary consent of State insurance commissions and legislative bodies to implement its recommended standards, but the record shows that consensus decisions have not achieved uniformly high solvency standards throughout the United States. Furthermore, the NAIC's attempts to police compliance with its "mandatory" accreditation program are both clumsy and ineffective, because they reverse the appropriate lines of authority between the NAIC's members and the State legislatures which sponsor and fund them.

In addition to developing standards, the NAIC can be a good resource for providing analytical and database functions to support State supervision. It plays an equally important role in arranging regular meetings attended by State commissioners to discuss significant issues. The organization already analyzes the condition of selected companies on a national basis, and serves as a central repository for insurer financial reports collected by State commissions. These largely successful efforts provide the NAIC with staff and computer system capabilities that can be used to advance individual State monitoring of the vast majority of insurers which play by the rules promulgated by supervisory authorities.

The NAIC can perform many tasks at the national level that would be difficult for its member commissions to accomplish individually as State agencies. However, the NAIC is not a regulatory agency, and it faces serious problems when attempting to engage in enforcement matters, as it has with the Special Activities Database. The SAD system could be useful as a comprehensive computer reference for published materials relating to insurance companies and supervision, but it is unproductive in its present form as a high-tech hotline to record the unofficial sightings of troublemakers by State regulators. Other projects to value insurer investments and rate alien insurance companies have also yielded unimpressive results. Fortunately, far superior products are available to regulators from the commercial ratings services. For example, the Standard & Poor's organization shares its domestic and alien insurer ratings with the NAIC and State insurance commissions without charge.

Finally, the NAIC has been accused of endorsing overly vague standards which can easily be met by any State. While this approach may have been necessary to reach the targeted number of certified commissions quickly under the group's accreditation program, it does little to raise the minimum level of standards that the NAIC itself has found are deficient. There is no apparent benefit to establishing feeble rules, nor is there any honor gained by State commissions for passing them. Even if they are controversial, explicit model rules that are well-researched have more use as rec-

ommendations for State legislatures and other rule-makers to consider.

(2) State Insurance Commissions. State regulatory agencies are the frontline guardians of solvency in the United States. Although their powers are circumscribed by limited jurisdiction, there is much they can accomplish as direct regulators who license and supervise the business activities of individual companies, brokers, and agents. In recent years, a majority of State commissions have substantially upgraded their legal authority and staff resources to deal with the rise of insolvencies, but they still have a long road ahead.

The best way for State insurance commissions to help solve national solvency problems is to master the tasks which lie within their powers. State commissions need to shake their preoccupation with rule-making, and move aggressively to upgrade their capabilities for conducting sound examinations of insurers and reinsurers. Hands-on monitoring improvements must be applied across the board to all companies in order to detect and stop those which are incompetent or dishonest. Because distinctions between the good and bad operators are not always immediately visible, sophisticated and efficient analytical techniques should be developed to focus on the business transactions, affiliate relationships, reinsurance arrangements, and investment strategies which largely determine the overall financial health of insurance companies. Examination procedures inherited from the last century, such as verifying all policy and investment portfolio serial numbers, should be reduced in favor of accurately monitoring modern business deals that move at lightning speed.

Enforcement is another area where vast improvement is needed. Regulatory inquiries and background checks on specific persons and companies can be indispensable in spotting trouble. When violations are found, State commissions must issue appropriate administrative orders, obtain civil court relief, and make criminal referrals that create an enforcement record and punish offenders. These official actions are more reliably shared with other insurance supervisors, and they send a clearer deterrent message to people contemplating foolish or wrongful acts.

The subcommittee also recommends that State insurance commissions closely inspect the qualifications and activities of independent brokers and agents, especially those handling reinsurance and surplus lines coverage. Every significant property/casualty company failure has involved extensive participation by such intermediaries working on commissions, and they have been the chief conduit for transferring policyholder funds to unsound and unscrupulous destinations around the globe. In the life insurance industry, a number of agents have intentionally misled customers about policy risks and benefits at great expense to innocent victims.

Lastly, State commissions should make routine fact-finding reports regarding the causes of actual insolvencies. Without these, regulators and the public have no reliable or comprehensive record to guide corrective measures and follow the trails of individual troublemakers. As liquidation receivers, State regulators have the necessary access to company records, as well as to former man-

agers, employees, and customers who can provide the information required to tell the real story.

(3) The Federal Government. The subcommittee has investigated solvency weaknesses, and concluded that strong national standards, effective enforcement, and regulatory controls over unlicensed alien insurers and reinsurers are necessary. How shall these reforms be instituted? There are many arguments regarding the respective benefits of State regulation versus Federal regulation of insurance companies. Behind this debate, however, is one uncontestable fact: The Federal Government is the only entity in the United States possessing the legal authority to regulate insurance matters affecting interstate and foreign commerce.

Whether or not Federal insurance regulation is considered to be desirable, Federal involvement is clearly necessary to implement a unified national program which raises solvency regulation to an acceptable level. The NAIC, along with others who vehemently oppose Federal regulation on principle, has recognized this reality by proposing that Congress grant the seal of Federal Government legitimacy to their programs. They also joined in asking Congress to extend Federal criminal penalties and investigations to punish people who violate the legal requirements of State governments.

After due consideration, the subcommittee recommends that Congress, at a minimum, enact legislation which will use Federal Government authority to achieve the following results:

(a) All insurers and reinsurers not licensed in the United States must be supervised by a Federal agency, appoint that agency as an agent for receiving service of legal documents, post adequate financial security, and report information equivalent to that reported by licensed companies in order to do business with policyholders in this country.

(b) Regulatory information exchange agreements should be negotiated with every foreign country serving as the domicile for insurers and reinsurers doing business in the United States, and companies based in jurisdictions that do not share regulatory information with authorities in the United States should be banned from this market.

(c) Any insurer or reinsurer engaged in interstate commerce must be required to comply with Federal standards for capitalization, investments, reinsurance arrangements, broker and agent relationships, and affiliated company transactions; and Congress must actively continue to monitor the financial condition and operations of insurers and reinsurers operating in interstate commerce.

(d) Until Federal standards and enforcement are established, Congress must continue to examine the interstate and international activities of State insurance regulators.

(4) Private Industry. There are several actions that insurance industry participants could take by themselves to enhance solvency in the marketplace. The first would be to employ more sophisticated use of commercial ratings services. Currently, insurance companies can choose to receive a thorough financial and business evaluation, including on-site visits, from independent ratings services which issue a public report of their findings. This process has the advantage of using the common methodology and market rep-

utations of ratings experts, but it costs money and is not generally employed by insurers concerned about receiving a poor rating. In addition, the ratings services focus their reviews on financial factors, rather than the broader background inquiries demanded by good regulators.

The self-interests of companies, brokers, and agents seeking to place their business with solvent and well-managed insurers should help increase the use of sophisticated commercial ratings. Such ratings should also be expanded to include broader issues affecting an insurer's business practices, in recognition of the larger concerns of supervisory authorities and the public. They would be even more useful if the ratings services developed easily understood grades and explanations to convey their findings, instead of the arcane combinations of alphabets and symbols now in vogue.

Similarly, insurance providers could establish their own betterment programs, either individually or under the auspices of a business trade association. Other industries have developed public oversight boards and independent review programs to enhance their credibility, but the success of such efforts depends on how acceptable they appear to objective observers. Self-review programs are also a useful alternative for foreign-domiciled companies needing to establish their equivalence with American competitors, especially those companies which are based in countries where government supervision and financial reporting are seriously deficient or overly secret.

Private industry initiatives in the United States and overseas cannot replace proper governmental supervision, but they can help to show if a company goes beyond the minimum regulatory requirements, which are often unsatisfactory. For insurers with nothing to hide, rigorous commercial ratings and self-help programs can be a useful way to overcome rising public anxieties about solvency, and establish their credentials with market participants, customers, and regulators. To the extent that supervisory agencies find these steps credible and useful, they may be able to target their primary efforts on insurance companies which avoid independent scrutiny.

PART II

SOLVENCY PROBLEMS: THE BEAT GOES ON

When the subcommittee issued *Failed Promises* in 1990, many State regulators and insurance industry representatives applauded its focus on the importance of solvency regulation and the immediate need to correct weaknesses in the system. Unfortunately, there are recent signs that a dangerous complacency has crept into the attitudes of people responsible for implementing such reforms. Relaxed attitudes apparently stem from notions that the insurance industry excesses which occurred in the 1980's have stopped, and that sufficient regulatory improvements have been made to prevent their recurrence. These are serious misconceptions, but the resurgence of such views so quickly is a testament to the power of the wishful thinking behind them.

The record compiled by the subcommittee confirms the continuing existence of major loopholes in domestic and foreign supervision of insurance companies. *Failed Promises* dealt primarily with problems in the property/casualty industry, including the proliferation of uncontrolled agents and brokers, exotic reinsurance arrangements, false reporting, speculative underwriting, inadequate loss reserves, and scurrilous transactions with affiliated companies. Many of those problems have persisted, and the regulatory changes made to date are insufficient to provide reasonable assurances that property/casualty abuses will be effectively curtailed.

Correcting known weaknesses is crucial because the financial impact of property/casualty disasters is growing. Insurance losses for the first half of 1994 from winter storms, the Los Angeles earthquake, and other catastrophes exceeded $8.5 billion, making it one of the costliest periods ever for the property/casualty industry. Hurricane Andrew in 1992 demonstrated how a single natural disaster could result in claims payments of $16.5 billion, and the economic consequences would have been far worse if the storm had passed through the heart of Miami a few miles to the north. Killer storms that can sink insurers are being matched by the effects of manmade disasters. The A.M. Best Co., an insurer ratings service, has predicted that insurance companies will face environmental and asbestos claims having a present value of $132 billion over the next 25 years, but just $15 billion has been paid or reserved on those claims so far.

Since 1990, a rash of high profile insolvencies has also tarnished the life/health side of the insurance industry. Hazardous business strategies, bad investments, lax internal controls, and holding company manipulations all contributed to the failure or near demise of several big companies bearing household names. The severity of these problems was fully revealed when an inevitable economic

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downturn exposed imprudent operating and investment practices. Increasing competition from mutual funds and investment companies generates continuing long-term strains for life insurers, because the pressure to match higher and riskier rates of return conflicts with the prudent investing needed to assure eventual cash pay-outs to policyholders and pensioners.

Some officials take comfort from the fact that insolvencies constitute only small percentages of the total number of insurance companies and their gross assets. This misplaced viewpoint ignores the real size of failed insurers and the related impact on the public. In 1992, the gross assets of insurance companies in the United States totaled $2.3 trillion. Even small percentages of such an immense amount leave billions of dollars in unpaid claims, and the effects on the individual victims are devastating. Because insurance is a financial product based on trust, the costs to the industry from diminished public confidence are immeasurable.

Standard & Poor's predicts that insurer insolvencies will remain an important concern during the foreseeable future. Although the actual number of failed companies dipped in 1993 from the historical high reached in 1989, there were still 47 insolvencies with an estimated public cost of $2 billion. Moreover, the 1993 statistics showed again that company failures were spread across all types of insurance, and that large multi-state insolvencies are growing in number and effect. Solvency problems are often hidden behind strong cash flows and respectable reported profits, so the symptoms cannot always be detected through the financial ratios and warning signals relied upon by regulators in the past. Standard & Poor's urges caution because many insurance companies have benefitted temporarily from better investment returns and market conditions, without correcting the underlying business weaknesses which make them vulnerable to financial reverses.

YOU BET YOUR LIFE: THE FIRST EXECUTIVE SAGA

Starting in 1990, the subcommittee widened the scope of its solvency investigation to include the serious financial setbacks and failures which were engulfing the life insurance industry. While most people hope that luck and the law of averages will protect them from calamities where they need to collect from property/casualty companies, almost everybody expects to eventually collect on the cash benefits sold through health insurance, retirement plans, and life insurance policies. However, public expectations were shaken when fundamental changes in the marketing and investing practices of life insurers caused several huge companies to founder, resulting in a sudden realization that life and health benefits planned long ago could evaporate overnight.

A number of troubled and insolvent insurers made headlines in the newspapers, including venerable mainline providers like Mutual Benefit and the Equitable, aggressive high-fliers like Fidelity Bankers and First Capital, and apparent frauds like Guarantee Security Life in Florida. Of all these, the most egregious and well-publicized was the First Executive empire run by Fred Carr, with assistance from Michael Milken. This group of companies literally gambled away its policyholders' security through almost every type

of management abuse that has concerned the subcommittee, and State regulators did little to stop them.

The three major players in this episode were the Executive Life Insurance Co., based in California, its Executive Life subsidiary, separately domiciled in New York, and First Executive, which was a publicly traded holding company that owned both the California and New York insurance companies. As chief executive officer, Mr. Carr used these three companies to construct one of the largest insurance organizations in America in just 10 years. The numbers are staggering: Reported assets of Executive Life in California skyrocketed 1,578 percent from 1980 to 1990, and the assets of Executive Life in New York leapt 1,273 percent during the same period. By 1990, First Executive had become the 15th largest life insurer in the United States with combined assets exceeding $19 billion.

Mr. Carr and his associates achieved their heady success by turning the Executive Life companies into high-risk investment funds which obtained capital from the public under the guise of insurance policies, annuities, and guaranteed investment contracts. Risky investments in junk bonds and speculative real estate yielded very substantial short-term profits that enabled the Executive Life insurers to beat their competition in the insurance industry. They attracted hordes of policyholders who were delighted to earn generous rates of return equivalent to the investment markets, while maintaining their funds in the secure hands of State-regulated insurance companies. The obvious defect in this happy scenario was that the generous earnings propelling the First Executive empire were produced by businesses with inflated values that would easily falter.

During its heyday, First Executive amassed more than 60 percent of its insurance assets in the volatile and exceedingly risky junk bonds peddled by Michael Milken through the Drexel Burnham Lambert investment firm. These bonds paid very high interest because they were issued and backed by marginal corporations, which could not qualify for the lower interest capital offered by traditional securities and bank loans. When the junk bond market began to collapse precipitously in late 1989, gigantic writedowns in the investment portfolios at Executive Life in California triggered a policy redemption rush by worried customers. The rush exposed the underlying financial vulnerability of First Executive, and sank the Executive Life insurance companies in 1991.

The subcommittee reviewed the events surrounding the demise of First Executive and its insurance subsidiaries during public hearings held on June 18, 1990, May 22, 1991, and September 9, 1992. The purpose of those hearings was to explore how First Executive had gotten into such a dire position while its insurance companies were being regulated by California and New York, two of the Nation's leading insurance supervisors. First Executive's fatal slide into disaster occurred gradually over a 10-year period, as Mr. Carr guided the marketing and investment strategies which plainly abandoned prudence in order to garner more customers and premiums. Why did the regulatory agencies fail to act during all that time?

NO SAFETY IN NUMBERS

At the first hearing in June 1990, the Executive Life companies were still in business, although they were reeling from bad publicity and customer withdrawals. Mr. Carr appeared at the hearing with a slew of robust numbers, industry comparisons, and an undisclosed actuarial study to rebut suggestions that his companies were on the brink of failure. He boldly asserted that First Executive and its subsidiaries passed all liquidity and asset strength tests with flying colors, and said that in the long term, "our investment strategy will be proven, overall, to be sound and our company will continue to be among the Nation's most successful insurers." Heartened by the apparent support of State regulators, Mr. Carr said: "Of particular note, of course, are the views of our State insurance regulators, who have consistently confirmed our solvency." In addition, he was probably heartened by a new management contract awarded in 1989 as his companies fell apart, guaranteeing him a $600,000 annual salary, a generous expense account, a $2 million insurance policy, and a $6 million severance allotment.

The subcommittee also invited the regulators from California and New York to present their views on the Executive Life companies. California's insurance commissioner refused the invitation to testify, but sent a written statement which generally backed Mr. Carr's assertion that Executive Life could meet its policyholder obligations under any adverse conditions. New York sent its acting superintendent and the director of the insurance department's life division. They expressed great confidence that policyholders of the New York subsidiary were fully protected from any problems which might occur in California or other parts of the First Executive organization.

Despite the optimism of Mr. Carr and his regulators, the newly-elected insurance commissioner in California placed Executive Life under State conservation on April 11, 1991, and New York did the same 4 days later in order to preserve the assets of the Executive Life subsidiary in that State. The subcommittee held its second hearing the next month to follow-up on the causes of the takeovers, and to gauge the effectiveness of the State regulatory system in dealing with this enormous national insolvency affecting the residents of all States. That hearing, which featured testimony by the NAIC leadership and the insurance commissioners from California and New York, disclosed some astonishing discrepancies between the goals espoused by the NAIC and the actual behavior of State regulatory commissions.

In their prepared testimony, the NAIC leaders vigorously defended the quality of State insurance supervision, contrasting its success with the failure of Federal agencies to prevent massive insolvencies in other financial industries. They specifically pointed to the benefits of having 50 separate agencies supervise insurance, because the sheer number of regulators meant that ineptitude or indolence at one commission would not affect the entire country or stop others from taking necessary actions. Moreover, they noted that each State commission, while serving to check regulatory problems elsewhere, could simultaneously be innovative in trying different approaches to supervising solvency.

Although the NAIC's theories of regulatory cooperation and competition to excel sound appealing, the prelude and finale to the Executive Life takeovers display a distinctly less flattering portrait of multi-state supervision in handling a huge national insurance empire. Here are the facts elicited at the subcommittee's hearing:

• The regulators in other States relied entirely upon California and New York to supervise the Executive Life companies, rather than having many separate checks by different commissions on the company's excesses. Nobody else took any action until the insurers' collapse was imminent.

• There was minimal communication and cooperation among State agencies. Dating back to 1980, New York had found bogus surplus relief reinsurance and serious management wrongdoing. In February 1987, the department finally ordered a $250,000 fine and a $151 million capital infusion, and also banished the California company and the offending officers from New York. The California commission did not discover these regulatory actions until 3 months later, after the $151 million was paid without notice in violation of California law. While praising New York for looking after its own interests, the new California commissioner said the First Executive holding company basically "raided Executive Life of California to protect the New York company." He criticized the California commission for not protecting its home-State interests.

• State regulators did not share important information. The Minnesota commission became deeply concerned about the condition of Executive Life in early 1990, and sought to obtain current information from California. The California commission would not provide such data or agree to an immediate examination of the company. When Minnesota threatened to send its own audit team to the company, the NAIC intervened to keep supervisory control with California in exchange for its agreement to be more cooperative. Moreover, New York did not make the results of its 1986 examination available to other agencies until 1990, even though violations uncovered during the process resulted in reserve penalties of $170 million and another $50 million capital contribution from the California company.

• The tough regulatory vigilance boasted by the NAIC was absent for the Executive Life companies, which would have been insolvent as early as 1983 without phony reinsurance to boost their reported surplus. New York belatedly ordered a halt to the reinsurance in 1987, and tried to isolate its subsidiary from the main company. California had dawdled on the reinsurance matter since 1984, and ultimately gave First Executive a couple of 3-year grace periods to fix it. First Executive was also bolstering the reported capital of its insurers with borrowed money from selling its own junk bonds, which required expensive debt payments from insurance income. Without surplus infusions from Executive Life to its New York subsidiary and from First Executive to the California company, both insurers would have been statutorily insolvent in 1986. Near the end of this capitalization charade, the California commission attempted to force Mr. Carr to get its approval before making significant expenditures. He told them that would hamstring the company and cause certain bankruptcy, so the commission relented.

• The NAIC's Securities Valuation Office, which is supposed to catch improper investments, allowed First Executive to create the illusion of investment grade securities by transferring $789 million of junk bonds to affiliated companies in exchange for new securities that were collateralized by the junk bonds themselves. This clever maneuver permitted Executive Life to appear more solvent in 1988 by reducing its statutory reserves for bond losses. After outside analysts complained that the securities swap was a sham, the California commission made Executive Life reverse the deal in 1989.

• Although State regulatory agencies have existing general powers to order an insurer to halt any practice which might result in hazardous financial condition, no agency used these powers against the Executive Life companies. New York finally issued a specific regulation in 1987 limiting junk bonds to 20 percent of a company's portfolio, but it was not applied to Executive Life retroactively because such spendthrift ways were considered to be an "integral part" of the firm's pricing policies.

• The NAIC proclaimed in its testimony that State regulators took early action by forming a multi-state working group in January 1990 to coordinate supervision of the Executive Life companies. This group was led primarily by California and New York, the agencies which had been responsible all along for letting the situation reach a crisis. At least two expert studies and an on-site examination were commenced, and many special reports were ordered from the companies, but the NAIC could not point to any specific regulatory actions arising from this group. During the year-long period of intensified study by State regulators, Mr. Carr sold the best securities held by the insurance companies in order to pay for policy cancellations. The junk securities were the primary assets left when action was taken by the new California commissioner in April 1991.

WAR BETWEEN THE STATES

A widespread revolt by Executive Life customers finally put a stop to First Executive's profligacy. While State regulatory agencies were stewing over the appropriate course to take, the flood of cash withdrawals by policyholders seeking to recover their money pulled the plug on the insurance companies and Mr. Carr's grand designs. In a complete reversal of roles, the State commissions acted to protect the companies from their customers, and the customers took their own personal actions to protect themselves from insurer insolvency.

Efforts by the NAIC to arrange a cooperative State response to the solvency problems posed by First Executive ended in acrimony. The New Jersey Insurance Department sparked the simmering self-interests of each State by demanding in late 1990 that Executive Life post a $500 million deposit in order to continue doing business in that jurisdiction. This demand irked the NAIC's working group and the lead regulators in California and New York, who were urging restraint by other States so that their monitoring activities could permit Executive Life to recover financially for the benefit of all. As the market situation grew worse and trust among State agencies diminished, the NAIC decided to defend Executive

Life by aggressively attacking the New Jersey Department for losing faith in the joint wisdom of other State commissions.

At an extraordinary plenary session in December 1990, the NAIC unanimously passed a secret resolution castigating New Jersey for acting unilaterally to preserve the interests of its residents. The resolution used strong language to cite "the expert opinion" of the NAIC's working group that "the Executive Life Companies are in no imminent financial danger . . ." It went on to call New Jersey's actions "unacceptable" to the NAIC, and requested that other States "not take unilateral action" and "not be influenced" by the New Jersey Insurance Department. The primary conclusion stated:

> NOW, THEREFORE BE IT RESOLVED that the NAIC believes that the action taken by the New Jersey Insurance Department is irresponsible and contrary to the best interests of New Jersey policyholders and all policyholders of Executive Life Companies . . .

The resolution was distributed to State insurance agencies with an attached confidential letter, dated December 27, 1990, to all commissioners from the NAIC's working group. This letter reiterated the group's expert opinion that Executive Life was OK, provided supporting data, and reminded the commissioners that California, New York, and other States had "carefully monitored" the companies since January 1990. Concluding that "the companies are capable of meeting all current and projected obligations," the letter warned that "unnecessary and precipitous regulatory action" could harm their long-term viability.

Four months later, Executive Life was ordered into State-controlled conservation by the new California commissioner, who assumed office in January 1991. The subcommittee thereafter received copies of the secret resolution and accompanying working group letter from anonymous sources. These materials were used to question the NAIC leaders about their actions and inactions as the Executive Life companies plummeted toward insolvency.

QUESTIONING THE EXPERTS

It was not clear from the answers given to the questions of subcommittee members whether or not the NAIC knew what was happening at Executive Life when the secret resolution was adopted. On its face, the resolution confidently affirmed the continuing financial strength of the company only 4 months before it failed. Asked how they could make such a prediction that proved to be so at odds with the facts, the NAIC leaders first replied that the resolution did not say what they really meant. They claimed that it was a secret warning intended for New Jersey alone, and that public release of the imprecise language was "unfortunate." Nonetheless, they distributed it to every insurance commission across the country.

When pressed by the subcommittee regarding why they would vote for a document that did not say what they meant, the NAIC leaders admitted that their intention was not reflected in the language they unanimously endorsed. They argued that, under the circumstances, regulators would have understood that the resolution actually said New Jersey should wait until an investment firm

completed its study of the company's assets. One commissioner commented: "It doesn't say that. I wish it was a whole lot more specific."

The subcommittee next asked if the NAIC knew, when the resolution was adopted, that Executive Life would go broke 4 months later. The commissioners present responded that they did not know it would go broke. Their lack of awareness regarding the real situation at the company conflicted with their previous assertion that intense monitoring by the NAIC working group provided expert knowledge that Executive Life would survive. When the subcommittee chairman observed that the NAIC did not appear to know what it was doing, one of the commissioners said, "I certainly can see how you can come to that conclusion."

A series of questions then ensued on the topic of the failure by State regulators to stop Executive Life's excesses over a 10-year period. The NAIC leaders all answered that they relied on the judgment of California and New York, and that they would have taken action if they thought California was abdicating its responsibilities. Concerning earlier NAIC claims of multi-state checks on companies, the witnesses made no clear response to the subcommittee chairman's statement that they were not protecting their constituents if everyone ceded supervisory responsibility to California.

The leaders excused supervisory inaction by saying there was no specific restriction on junk bond amounts, but then agreed that placing 60 percent of assets in one area "certainly" overexposed the company. They further agreed that State regulators had general authority to prevent hazardous investments. The NAIC witnesses countered, however, with the argument that other financial regulators were equally indulgent about junk bonds in the 1980's. According to one witness, "We are paying the piper for that unfortunate regulatory misjudgment . . ." He promised that State insurance supervision would be corrected to prevent the same situation "in the next cycle."

The NAIC testified that the record of State regulators, as well as the benefits derived from multiple agencies, warrants trusting them to continue without Federal intervention. This assertion was not supported by the responses to several questions relating to actual insolvencies. For example, the Executive Life case highlighted differences in the quality of State supervision at separate times and places. As justification for these variations, one NAIC official said the company's situation was "considerably different" in March 1991 than it was in December 1990, when the organization passed its resolution defending the insurer's financial health. Asked what had changed, he responded, "There was a new administration in the California insurance department." His answer implicitly recognized that temporal politics at State commissions can cause wide fluctuations in regulating solvency matters.

In another example, the New York superintendent illustrated the conflicts among different States by calling New Jersey's action "a vain thing." He explained: "They knew that the company couldn't put up $500 million and that the request was just something that would perhaps put them on the front page of the Wall Street Journal and perhaps, at least put them in good light with the voters,

but that nothing was going to be accomplished by that, except that perhaps a panic would be created."

Additional subcommittee inquiries elicited agreement from the NAIC leaders that residents of all States are harmed when a State such as California does not meet its regulatory responsibilities in costly cases like Mission, Transit Casualty, First Capital, and Executive Life. In reply to a query contrasting State behavior in these real cases with the NAIC's assertion that the State system is superior, the organization's past president stated, "The fact of the matter is that anecdotal insolvencies do not necessarily justify systemwide performance."

Although NAIC witnesses expressed a variety of sentiments regarding the causes for the Executive Life takeover by State authorities, the prevailing viewpoint was that the regulatory community relied upon the California commission, which did not do as well as expected. One commissioner noted that, in retrospect, "it probably would have been in everybody's best interest if we would have shut off that spigot." The new insurance commissioner in California flatly blamed the previous head of his agency for failing to acknowledge clear danger signs for many years.

New York's regulators refused any responsibility for the collapse of Executive Life, saying the subsidiary under the department's supervision was "well-funded," and the victim of a "run on the bank" by confused policyholders who forced it into State control. The New York commissioner, deflecting criticism of his agency's laxity, attributed the company's heavy dependence on junk bonds to "a pyrotechnic interest rate environment" that caused an insurance industry scramble to satisfy consumer desires for greater investment returns. He praised his department for having the foresight to protect New York's interests by demanding cash and stronger corporate accountability, without mentioning the detrimental effects of such actions on the interests of policyholders in other States.

The most telling comment, however, came during a subcommittee interview with a senior official at the California commission who had participated in supervising Executive Life for several years. According to him, nobody employed by the California commission had sufficient expertise to evaluate the aggressive new investments being made by companies like Executive Life. When asked if he believed the NAIC or other State regulatory agencies possessed such expertise, he replied "no." The official just shrugged in response to the question of how a commission could claim to supervise an insurance company without understanding its investment portfolio.

WHERE ARE THEY NOW?

Failed Promises told the stories of the largest insurer insolvencies which were known prior to 1990. Through tracking the paths of the people who caused those failures, the subcommittee discovered multiple examples of outrageous and irresponsible conduct by greedy opportunists, bungling executives, obscure crooks, and mainstream firms looking for easy money. Several cases continued to fester as unfinished business for the subcommittee after *Failed Promises* was issued, and the facts now show that a few of the principal offenders were linked to other outlandish ventures which were still underway at that time. Incredibly, key aspects of those

related ventures were even more damaging and bizarre than the ones described in *Failed Promises*.

The whereabouts of certain persons featured in the original stories are well known. Carlos Miro, Willie Schonacher, and James Wining were ultimately convicted on Federal fraud charges. Mr. Miro and Mr. Schonacher are now serving their sentences in prison, while Mr. Wining succeeded in avoiding jail because the judge felt he should remain on probation to take care of his troubled son. Five of Mr. Miro's cronies were also convicted, and two more are awaiting trial on Federal fraud charges.

The key players responsible for the Transit Casualty mess have fared much better. Joseph Mitchell, former chief executive of the holding company which owned Transit, is presently the president of American Investors and Consultants, Inc. in Los Angeles. George Bowie, Transit's former chairman and chief executive officer, has resurfaced in the insurance industry as general counsel of Lancer Insurance Co. in Grants Pass, Oregon. As described in *Failed Promises*, both Mr. Mitchell and Mr. Bowie sold their stock options to the company in 1984 at generous profits, just as the Transit Casualty web was coming undone.

The subcommittee's investigations revealed scores of insurance executives, brokers, and agents in the United States and foreign countries who were deeply involved in causing devastating insolvencies. Of the many people identified as apparent violators of State insurance laws and regulations, Mr. Bowie is unique in being the only person who was ever charged by State authorities with any wrongdoing. He was acquitted of a 1989 State criminal complaint that he knowingly filed false regulatory reports with the Missouri commission. The deplorable record of State authorities in not seeking administrative, civil, and criminal sanctions for obvious violations of their own laws and regulations has been a great concern in evaluating the effectiveness of State insurance supervision.

Since 1990, the subcommittee has continued to find numerous examples of unchecked avarice and incompetence by people entrusted with providing insurance security to policyholders. The boldest gambits assailed common sense business methods, but were enthusiastically welcomed by profitmongers in the marketplace who fueled their growth. Other cases demonstrate how even small-time shenanigans in the insurance industry can support an opulent lifestyle. Regulators in America and Europe did not prevent the substantial harm caused by such further assaults on the insurance system, and some of the perpetrators are still on the loose.

TRANSIT CASUALTY: SALVAGING THE TITANIC

The Transit Casualty story is an excellent vehicle for examining the myriad ways company insiders can abuse and destroy an established insurer while pursuing quick profits and grandiose expansion dreams. A subcommittee hearing on March 12, 1990 and follow-up investigations revealed additional twists and turns in a troublesome tale that was already breathtaking in scope. Updating the tale of events which led to Transit's demise now involves recognizing the importance of business transactions and relationships in Chicago, London, Liechtenstein, Bermuda, and the People's Republic of China.

The subcommittee provided a detailed account of the failure of Transit Casualty Co. in *Failed Promises*. Termed the "Titanic" of insurer insolvencies by Transit's liquidation receiver, this 1985 debacle still maintains its ranking as the most expensive property/casualty failure ever in the United States. The Transit case is a story of brazen exploitation and regulatory neglect that is truly gargantuan in every respect, from the idiocy of the company's management schemes to the estimated $4 billion that it will cost innocent victims across America. The end result is a monumentally complex liquidation process that may not be completed until the year 2012, because long-term claims will take years to develop and many of Transit's reinsurers are bankrupt or refusing to pay.

The receiver for Transit told the subcommittee there are more than 40 recalcitrant reinsurers around the world which collectively owe the receivership over half a billion dollars. Each one must be pursued separately through arbitrations and civil litigation in various legal forums here and abroad, which makes the salvage effort very time-consuming and expensive. Transit's receiver testified that his job would be much easier if the Federal Government required the alien reinsurers doing business with companies like Transit Casualty to register in the United States, report adequate information, and submit to the jurisdiction of the Federal court system.

The insolvency problems at Transit Casualty began in 1978, when its business orientation drastically changed from writing commercial transit, bus, truck, and fleet coverage to acting as a "fronting" insurer that rented its name for a fee. In essence, the company's management abdicated responsibility for running Transit's insurance business by delegating its operating authority to an assortment of independent agents working around the country. The company appointed 27 autonomous managing general agents to represent Transit Casualty, and granted them complete authority to issue insurance policies using the company's name and reputation. By "giving its pen" to this multitude of agents, Transit's business expanded geometrically through all 50 States, and it soon had reinsurance arrangements with approximately 900 companies located in 30 foreign countries scattered around the world.

The switch to being a fronting company was accompanied by a wholesale shift in the types of insurance coverage which Transit started accepting. New policies produced by the network of agents were heavily concentrated in the areas of high-risk commercial property and general liability insurance for major corporations and litigious occupations. Management at Transit Casualty had no experience with such business lines, and also had no record-keeping system to monitor the abundance of policy information and financial reports which the managing general agents were supposed to submit to the company.

The original plan was to get rich quickly by letting the army of independent agents do all the work, while Transit collected a fronting fee on every policy written. In return for getting a supply of authentic blank policies from a fully-licensed insurance company, the agents promised to find customers, issue policies, pay claims, post reserves, keep the books, arrange reinsurance, and remit a percentage of the premiums to Transit. This dumb ploy backfired mightily

when the agents, paid by commissions on the amount of business they produced, realized they were free to write as much as they could with no supervision from the insurer's management. They went on a spree of uncontrolled policy writing at bargain prices that eventually boomeranged to cause Transit Casualty's collapse when claims losses skyrocketed.

The fronting agreements required the managing general agents to obtain reinsurance which would pay Transit for losses arising from the policies issued in its name. Transit Casualty's management foolishly believed such reinsurance coverage would protect them from fronting mistakes by passing all the losses to somebody else. Since the insurer's management was incapable of monitoring the business activities of the agents, however, the reinsurance requirement was often satisfied by concocting deals with overextended American companies or weak offshore reinsurers. Carlos Miro, one of the agents, reinsured his Transit policies with a nonexistent company he created solely to keep more premium money for himself.

The unsupervised reinsurance arrangements were a sure recipe for disaster, just like the plethora of agent-produced policies written in Transit's name. Nevertheless, the need to obtain reinsurance was a practical limitation for most of the managing general agents, because it meant finding another company somewhere that was willing to reinsure the large volume of risky policies which Transit was fronting. Transit Casualty never had more than $47 million of capital surplus, so continual reinsurance was absolutely necessary to turn over its primary book of business in order to write more policies. Where could enough reinsurance be found to sustain Transit's rapid transformation from a modest-sized trucking and bus insurer to a $4 billion insolvency stretching around the globe?

Simply put, the Titanic of insolvencies needed a sister ship that was willing and able to carry a full load of the same foolhardy insurance schemes which would sink Transit Casualty. Incredibly, that vessel had already been assembled in London by a management team that found a prosperous, albeit temporary, market niche by throwing caution and common sense to the wind. Transit's sister ship was named London United Investments (LUI), and its insurance empire sailed under the banner of an unregulated managing agency operation called the "Weavers Stamp."

THE TITANIC'S SISTER SHIP IN LONDON

The fates of Transit Casualty and the LUI group of companies became inextricably intertwined over the years, but the London operation was far more sophisticated. The evidence indicates that LUI was instrumental in persuading Transit to undertake fronting agreements and get its own stake in the management fees and underwriting commissions generated by independent agencies. While Transit failed because its managers knew little and cared less about the perils of commercial liability insurance, the LUI group ultimately went bankrupt because its management arrogantly believed they knew everything about those perils. Neither could have ended in such turmoil without completely ignoring prudence, proper bookkeeping, sensible internal controls, and sound business

principles. Both companies avidly took advantage of regulatory loopholes.

Two facts are now clear: The relationship between Transit and LUI went far beyond normal reinsurance dealings. Among other things, the companies became joint owners of two managing general agencies they established in the United States. Second, Transit was definitely the junior partner, and could not have reached the heights of financial debauchery without major help from the experts at LUI. The chicanery, nonsense, and management abuses at LUI preceded the Transit fiasco, and continued for another 5 years after Transit expired.

As a vehicle for pursuing grand ambitions, LUI had many more resources than Transit Casualty. The LUI holding company was based in the active London market, had its own insurance companies, managed the affairs of several other insurers, and boasted the professional technical expertise of its in-house underwriting agency, named H. S. Weavers. The company even had Prince Michael of Kent, Queen Elizabeth's cousin, serving on its board of directors. He visited the United States as an LUI director, and reportedly was quite effective in attracting clients impressed by LUI's lofty connections.

The flagship of LUI's operations was a pool of insurers that provided substantial lines of insurance and reinsurance for commercial property/casualty risks in the United States. This pool was comprised, at various times, of 27 different insurance companies which had agreed to let the H. S. Weavers Agency issue policies and manage all related pool business on their behalf. During the 1970's, the LUI insurance pool included several reputable companies that gradually departed as Weavers moved into increasingly high-risk coverage, but a top German company continued to reinsure the pool until it disbanded in 1991. Customers generally came to H. S. Weavers through the LUI-sponsored agencies or independent brokers in the London market.

Insurers agreeing to accept a share of the pool business produced by Weavers were called "stamp companies," and they were collectively called the "Weavers Stamp." LUI itself owned six of these insurers, which were known as the KWELM[3] companies after their first initials. Most of the Weavers Stamp insurers were licensed and regulated in Great Britain by the Department of Trade and Industry (DTI). As an independent underwriting agency, H. S. Weavers was not regulated at all by the DTI, even though Weavers had full authority to obligate the stamp companies, pay their claims, set reserves, and account for premiums. The holding company, LUI, was supervised separately by DTI as a publicly-traded company listed on the London Stock Exchange.

LUI had a straight-forward plan for its Weavers Stamp: They would specialize in writing commercial liability insurance and reinsurance coverage for almost every high-risk Fortune 500 company in the United States. The LUI holding company, through its KWELM insurers, would participate in the expected underwriting income, and would also earn substantial management fees and un-

[3] Kingscroft Insurance Co. Ltd., Walbrook Insurance Co. Ltd., El Paso Insurance Co. Ltd., Lime Street Insurance Co. Ltd., and Mutual Reinsurance Co. Ltd.

derwriting commission profits from the agency activities of the Weavers subsidiary. With singular determination to fulfill this plan, they aggressively issued policies covering manufacturers of chemicals, pharmaceuticals, and hazardous building materials, as well as hospital and medical malpractice risks, directors and officers liability, and professional indemnity insurance for attorneys and big audit firms.

The Weavers operation was in many ways a mirror image of the dangerous methods used by Transit Casualty, except that Weavers wrote the business itself instead of farming it out to others. The Weavers Stamp fast became a market leader in covering corporate liabilities in the United States because it would provide coverage that other insurers avoided, and its prices were very reasonable. Understandably, it attracted droves of brokers and their corporate customers who were pleased to get affordable insurance for dangerous liability exposures. From rather small and obscure beginnings, LUI and the Weavers Stamp followed a predictable boom and bust cycle that lasted 15 years, and ultimately doomed LUI and all of its insurance subsidiaries to insolvency. The bubble finally burst in the early 1990's, when poor underwriting and adverse claims development bared LUI's exceedingly irresponsible strategy of concentrating its business almost entirely on risky commercial liability insurance.

Between 1990 and 1992, the LUI holding company, its H. S. Weavers underwriting agency, and the KWELM insurance subsidiaries all were placed in liquidation under the British court system. The ultimate costs to the public are currently projected to exceed $5 billion, making this failure the most expensive insolvency in history. The Transit receivership is a major creditor of the Weavers Stamp liquidation run-off because it is trying to collect $300 to $500 million of reinsurance recoverables. Current recovery estimates, however, are approximately 40 percent of the total, and the British liquidation process for the KWELM companies could take as long as 20 years to complete.

Investigating the Weavers Stamp phenomenon and the related failures of LUI and the KWELM companies has been a subcommittee priority since 1989. As it evolved, the tale of their rise and fall included the usual elements of frantic expansion, gambler underwriting, and international reinsurance delusions. It even became a crime story in the end. When Weavers began arranging reinsurance for the high risk policies produced at Transit, the stage was set for the exponential growth that ultimately caused a $4 billion failure at Transit Casualty and a $5 billion blight at LUI's insurance companies.

The impact on the United States of unmet claims from the bankrupt KWELM insurers is enormous because 95 percent of their business originated here. Substantial financial damages have been borne by many American policyholders, as well as The Hartford and Crum & Forster insurance companies. Those two insurers had unwise fronting operations similar to Transit's reinsured by Weavers. The obvious questions are, "Who created this $5 billion mess, and how did they do it?"

IN THE DRIVER'S SEAT AT LUI

The central force behind the emergence of the LUI insurance empire during the 1970's was a London market underwriter named C. R. (Ronnie) Driver. He started the H. S. Weavers underwriting agency and became its chairman in 1963, appropriating the firm's name from his chief underwriting partner in the enterprise, Henry Weavers. In 1971, he joined the board of directors at LUI when that holding company took control of the Weavers agency, and subsequently became LUI's chief executive in 1982. Described by others as "the boss" who was not interested in technical insurance details, Mr. Driver admitted his dominant personality by telling British investigators that he was "very strict over the running of the firm."

Mr. Driver pushed the expansion of LUI into risky insurance ventures. He personally shared in the wealth by running a portion of the new business directly through his privately-owned underwriting firm, C. R. Driver & Co., that was located on the LUI premises. Having expensive tastes for polo and socializing with English high society, he spent much of his time and LUI's money indulging these interests. Mr. Driver apparently left the actual insurance underwriting duties to Mr. Weavers and another officer at the company named Peter Wilson. Together, these three men formed the backbone of the LUI management team that vigorously chased the rich premiums generated by commercial property/casualty buyers in America. Later, they were joined in their endeavors by a much younger associate, Roger Borley, who rose quickly in the management hierarchy under the patronage of Mr. Driver.

Ironically, the LUI team perpetrated its reckless mismanagement under an aura of underwriting expertise and management acuity. From the early days until he retired in 1985 due to illness, Mr. Weavers was a respected underwriter in the London market. Mr. Wilson carefully honed an image of aloof knowledge and hard bargaining that still captivates some of his admirers, while Mr. Driver was viewed as the behind-the-scenes mastermind who orchestrated the LUI miracle. Only Mr. Borley, who became the principal underwriter at Weavers by age 35, admits to a few shortcomings. After the LUI empire collapsed, he cheerfully told the subcommittee that he possessed few credentials for his post, but defended his record all the same.

LUI acquired the Weavers agency and Mr. Driver's leadership skills in 1971. One of the first tasks during his tenure was creating a licensed insurer named Walbrook in 1972 to accept business underwritten by Weavers. As a wholly-owned shell company, Walbrook had no separate identity or independent judgment from the underwriting team at Weavers. This move marked LUI's initial step into accepting insurance risks for itself, and assured Weavers' success by providing the agency with a willing recipient for the policies it produced.

Walbrook was the largest of the infamous KWELM insurers, and the only one started by LUI. The other four bankrupt insurers were originally participating stamp companies that were later bought by LUI to keep the operation going when their disgruntled former owners wanted to quit the business. The KWELM insurers were all

run by the Weavers agency. Armed with an unregulated underwriting agency and subservient controlled insurance companies, LUI had the enviable ability to write its own ticket. Furthermore, other insurers could be enticed to join the Weavers Stamp with the boast that LUI had a real financial stake in the project's outcome.

Weavers used the KWELM companies it controlled to insure most of the business produced by the agency, and to pick up the slack when more cautious insurers departed the stamp. In 1978, the KWELM group took 55 to 60 percent of the Weavers business, but that amount steadily increased to 90 percent by 1987 before the companies began to fail. Walbrook was the last to stop writing new policies in 1990, when the Weavers Stamp had shrunk to two insurance companies, and Walbrook's single share was 55 percent of the total. In 1989 alone, Walbrook received net premiums exceeding $275 million from policyholders in the United States.

During their 10-year prime, the KWELM companies also served the ruinous LUI scheme as replacements and reinsurers for one another in an extremely complicated shell game that baffled outside insurers and customers into believing they were protected from weak providers. This "bait and switch" routine was so complex that nobody at Weavers really understood its impact, but that was unimportant since they were preoccupied with bringing more new business through the door. Such confusion has proven to be very costly as the liquidation experts now wrangle over who should bear the biggest burden of LUI's KWELM legacy.

COMING TO AMERICA

Once the Weavers Stamp was established in London as a beacon for American commercial risks, the next step was to export its underwriting magic to the United States. This feat was accomplished in 1977 when the LUI principals—Mr. Driver, Mr. Weavers, and Mr. Wilson—connected with the gullible and greedy senior managers at Transit Casualty in Los Angeles. They jointly set up Russell Re in Troy, Michigan as an underwriting agency that was majority-owned by Transit and, ostensibly, by LUI. As one of the 27 managing general agents given Transit's pen, Russell Re was intended to generate commission income while feeding new business to Transit and the Weavers Stamp. However, it never became a large producer for its parent companies.

A second jointly-owned agency, the National Underwriting Agency (NUA), was established by LUI and Transit in 1978 in Chicago, Illinois. Also appointed by Transit Casualty as one of its managing general agents with full authority to write binding policies, NUA played a pivotal role in bankrupting both of its parent companies. Unlike Russell Re, NUA was run with the same reckless abandon that characterized the Weavers Stamp operation, and it generated vast amounts of policy liabilities for Transit in return for modest premium income. The deleterious effects of colossal underwriting blunders at NUA were magnified when they were reinsured by Weavers using equally atrocious judgment.

Richard Foss was the chief underwriter and a part-owner of NUA during its glory days. Although heavily criticized by the Transit receiver for causing a lion's share of the company's losses, Mr. Foss staunchly defends his record and his skills. He described himself

as an expert underwriter who is well known in the market, and told the subcommittee that he could not have caused so much damage because NUA produced only moderate premiums. The actual numbers contradict Mr. Foss's assertions, which is not surprising since adequately pricing assumed risks was never a hallmark of the Transit and Weavers operations.

According to the receivership, NUA produced a total of $214 million in gross written premiums for Transit Casualty, but committed the insurer to $30 billion in coverage for a great many big corporations in such areas as pharmaceuticals, asbestos, and toxic wastes. Projected losses from the NUA business are estimated at $1.6 billion, giving Mr. Foss and NUA an eye-popping loss ratio of 745 percent. When the fortunes of NUA sank with the Transit failure, Mr. Foss became the chief executive of Geneva International Management, Inc., which manages certain syndicates on the Illinois Insurance Exchange in Chicago.

The Transit Casualty collapse in 1985 did not end LUI's presence in the United States. The Weavers Stamp kept going with its hefty imported American insurance risks, and LUI even acquired the First Reinsurance Co. of Hartford in an effort to replace Transit as a fronting company. With a steady flow of business brought directly to London and the reinsurance assumed from other fronting insurers in the United States, Mr. Driver's LUI empire was enriched by premiums from this country for at least 5 more years after the Titanic of American insolvencies slid beneath the waves of mounting losses.

WEAVING A WEB OF DECEPTION

The LUI operation departed the United States under surprising circumstances. While investigating the relationships between Transit and LUI, the subcommittee discovered an odd trustee arrangement that was insisted upon by Messrs. Driver, Weavers, and Wilson. In 1977, when they helped form Russell Re on behalf of LUI, the management trio secretly appointed a friendly American lawyer in Chicago to hold the ownership shares representing the LUI interest in trust. The Russell Re earnings attributable to LUI's ownership share quietly accrued in the trustee attorney's account until 1986, at which time he was instructed to send $210,000 to a mysterious agent in Liechtenstein.

When questioned by the subcommittee about this strange trust agreement, the Chicago attorney said he had acted on the personal instructions of the LUI management trio in holding the stock. He clarified that he never represented LUI's corporate interest, and admitted paying a secret dividend to Liechtenstein. At the request of his friend, Henry Weavers, the attorney also permitted a phony return of the dividend money to LUI through his client account when the company's board of directors learned about the Russell Re deal. The obvious purpose of that transaction was to conceal the personal appropriation of LUI's funds by its senior managers.

Apparently, nobody at LUI except Messrs. Driver, Weavers, and Wilson knew the publicly-traded holding company had an ownership interest in Russell Re. Although they were LUI's top executives, the Driver team never disclosed their American trustee arrangements and hidden Liechtenstein account. This omission fi-

nally came to the attention of LUI's board of directors in 1988 after a dissident director accused the senior management trio of siphoning company funds for their personal use, a charge they angrily dismissed. A nasty and extended board of directors feud ensued, which coincided with the company's financial reverses that resulted in LUI's tumultuous 1990 bankruptcy.

Later in 1990, the DTI commenced a government investigation to determine if LUI's corporate funds had been illegally diverted by Messrs. Driver, Weavers, and Wilson. The British investigators conducted a thorough investigation which lasted 3 years, and concluded in 1993 that the fracas about Russell Re was just the tip of the iceberg. They found that LUI's management trio had indeed sent approximately $53 million of company funds over the years to their secret agent in Liechtenstein. This series of unexplained multi-national transactions were clearly bogus, and the matter is now pending with the DTI and criminal prosecutors in Great Britain.

There are a number of curiosities surrounding the entire Russell Re episode and its aftermath. The LUI board row occurred after the Driver team boldly proposed in 1987 that LUI purchase the Russell Re shares which were originally bought with funds they secretly diverted from LUI. This effort at double-dipping was either an act of exceptional bravado or blatant stupidity, since it led to their downfall and possible criminal charges. Although the Russell Re agency was significant as the trio's first direct presence in the American market, it was relatively insignificant as a cause for the financial collapse of LUI's insurance empire. Furthermore, the commotion regarding possible criminal conduct at the holding company has clouded attempts to gain a better understanding of the underlying reasons for the $5 billion Weavers Stamp insolvencies.

There are very important public policy questions concerning how LUI and the Weavers Stamp were able to escalate into the world's biggest insurance insolvency without being caught by British or American regulators. These questions remain unanswered by the DTI's report on the activities at LUI, the Weavers Stamp, and the KWELM companies. The British government's inspectors narrowed their findings to specific examples of probable criminal diversion of corporate funds, and intentionally ignored the causes of the 15-year international insurance extravaganza which created the criminal environment at LUI. The failure to address these issues is especially disappointing, considering the substantial resources and time spent on the inquiry, as well as the enormous costs which have been inflicted on the public in the United States and Great Britain.

The LUI case offers some clear parallels with the insurer failures which the subcommittee has observed in this country. A publicly-traded holding company was used to facilitate the creation of an elaborate insurance organization whose key elements were not supervised by insurance regulators. While the real action was happening in the offices of LUI and H. S. Weavers, the only entities subject to review by DTI's insurance division were the KWELM shell companies, which dutifully filed their obligatory reports with the regulators. The accuracy of those reports, however, was skewed by bad information emanating from the Weavers underwriting mill.

Although the Weavers agency handled all the tasks which would normally be regulated at an insurance company, it did not employ any actuaries. The underwriting managers, with no apparent training or skills, even engaged in discounting loss reserves to present values in order to boost reported financial results. No actuaries were used at all until late 1989, when an outside firm was finally retained by management to head off intervention by the DTI. The independent actuarial review ultimately concluded that the KWELM companies could not meet required solvency margins, which led to their court-supervised takeovers.

The DTI's practice of relying on independent audit firms to report solvency problems and management wrongdoing did not work in the LUI case. The outside audit firm, KPMG Peat Marwick McLintock, did not report LUI's diversion of funds or its perilous management practices and financial condition. However, the DTI's own inspectors found deficient audit practices when they investigated the illegal diversion of funds at LUI, and other observers claim the evidence on record demonstrates auditor negligence and acquiescence in helping LUI's management cover their suspect activities.

Negligent auditing is a common companion to financial institution failures in the United States. As part of its investigation, the subcommittee asked the partner in charge at KPMG Peat Marwick McLintock in London how the LUI audit was conducted. He refused to answer when asked, among other things, if his firm used its own actuaries to evaluate loss reserves or verified transactions with the Weavers Stamp reinsurer in Germany. Nonetheless, the audit partner told the subcommittee his firm had done an "extremely professional job."

The lack of internal controls and screwy bookkeeping at the Weavers Stamp operation are also familiar signs of forthcoming disaster, yet these obvious weaknesses flourished for years without being stopped. The extent of the problems was vividly demonstrated when subcommittee representatives visited the Weavers offices in 1991, after the LUI bankruptcy. Roger Borley was the only former management principal left, and he was working for the liquidators who were trying to piece together the fragments of the Weavers Stamp policies. When Mr. Borley was requested to provide basic figures on the annual premiums, projected losses, and number of policies relating to business originating in the United States, he said that such key information was not available on computers or in any consolidated format. Asked how Weavers could operate without knowing the figures measuring its overall exposure, he replied they were unnecessary because there was always enough cash available to pay the daily claims.

The subcommittee's representatives continued pressing Mr. Borley to see the Weavers book of business in America. He first said, "There are six million bits of paper in this building, and you are welcome to search through all of them." Finally agreeing to show examples of the policy records, he produced some worn looseleaf school binders filled with yellowed pages. Each page contained handwritten pencil notations of customer names and coverage terms for a particular policy, and extra paper was taped to the page bottoms on the longer policies. As he flipped through the

pages reciting customer names aloud, Mr. Borley remarked that they truly did include every major high-risk business in the United States. Although the Weavers offices were located in a modern building near London Bridge, the records displayed by Mr. Borley for this multi-billion dollar insurance enterprise were reminiscent of a scene from a Charles Dickens story.

Where are the LUI principals now? The British government's inspectors report that the chief executive, Mr. Driver, is in poor health and experiencing memory lapses about details which might incriminate him. However, he clearly remembers that he is innocent of any wrongdoing. Mr. Weavers retired in 1985, and was ill for many years before his death in 1993. He also strenuously denied all charges of misconduct. Mr. Wilson at first refused to speak with the government investigators, but they obtained a court order to compel his cooperation. He begrudgingly complied, while complaining that he "resented the inquisitorial process." Mr. Wilson said that criticism of his conduct was "unfounded and unfair," and was based on "incomplete or misunderstood evidence and speculation." The inspectors rejected these accusations.

For his part, Mr. Borley remains active in London around the fringes of the world's biggest insurance failure. Perhaps drawing from his first-hand experiences and inside knowledge, he is now director of a consulting firm he started named Insolvency Aid, Ltd.

LOST IN THE BERMUDA TRIANGLE

Fallout from the Weavers Stamp debacle extends far beyond the United States and London. The Transit Casualty receivership has also found itself caught in a triangular reinsurance deal involving Weavers and the Bermuda Fire & Marine Insurance Co. Ltd. Through some clever corporate restructuring, the Bermuda company arranged to make the bulk of its business assets disappear into the pockets of its shareholders. The result of this dodge is to leave Transit, The Hartford, Crum & Forster, and other American creditors of Bermuda Fire & Marine holding reinsurance claims of $100 million, with few assets left to pay them.

Domiciled and regulated in Bermuda, Bermuda Fire & Marine has long served the domestic island market there, but also became involved during the 1960's with international insurance coverage in the London market. Until 1983, it was one of the Weavers Stamp companies which participated in reinsuring the high-risk commercial property/casualty policies written by Transit's team of managing general agents. Losses on the commercial liability reinsurance begin to mount significantly beginning in 1987, and continued to have a substantial negative impact on the operating results of Bermuda Fire & Marine in 1988, 1989, and 1990. In 1991, the company undertook a series of transactions which stripped its healthy domestic business from the reach of international creditors, and thereby shielded its Bermudian shareholders from the cascading losses coming from Weavers.

The first step was to form an investment holding company called BF&M Ltd. for the purpose of acquiring the profitable domestic business of Bermuda Fire & Marine. The insurer then transferred its domestic business and several subsidiaries to BF&M in exchange for 100 percent of the new holding company's stock. The

swap was valued at $56.6 million, which Bermuda Fire & Marine contended was the fair value of the assets as determined by "professional assessments." When this exchange was completed on September 5, 1991, the Bermuda insurer had succeeded in housing its good assets in a separate company which it still owned.

On September 10, 1991, the board of directors of Bermuda Fire & Marine declared a stock dividend, whereby all the shares of the BF&M holding company were distributed to the existing shareholders of the Bermuda insurance company. Thus, Bermuda Fire & Marine split its business apart only 5 days after separating its assets through corporate restructuring. By law, the shareholders receiving the BF&M stock dividend and ownership of the insurer's good assets must be at least 60 percent Bermudian. Traders at the Bermuda Stock Exchange immediately recognized the true values of the two companies by pricing the new BF&M shares at more than $9 each, while reducing the price of Bermuda Fire & Marine stock to just a nickel apiece. The old company has since been placed in liquidation with little money left for international creditors, who are contesting the stock exchange transaction in the Bermuda court system.

This transparent asset-stripping effort has been vigorously defended by the board of directors of Bermuda Fire & Marine, and even the Bermuda government. The board's chairman attacked the moves by creditors to have the transaction reversed in court. He said, "They do not appreciate or understand what we have done for them." The chairman also dismissed conflict of interest allegations arising from the fact that the board of directors sought no third party buyer to determine a fair price, and that the transactions were handled by an audit firm and a law firm with close ties to the board. According to him, "It's impossible to avoid conflicts of interest in this community." The board's chairman did admit that he was concerned about possible damage to Bermuda's reputation, which he blamed on bad publicity generated by creditors and the media.

Condoning the split, Bermuda's Finance Minister characterized the stock transfer as "correct," and said there was no need for him to get involved. He argued that nothing "illegal or improper" was done, and added, "They took measures to protect themselves and that is something not unheard of in the day-to-day activities in business." The Finance Minister refuted concerns about damage to Bermuda's reputation, saying: "I think the international business community will probably yawn. They will look at it as a little Bermuda company that dabbled in the big wide world and got burnt." He did not explain how the company "got burnt" if it fails to pay its creditors.

The Bermuda Fire & Marine episode is a prime example of outrageous irresponsibility by an offshore insurance company, exacerbated by a cavalier disregard for the consequences on people living elsewhere. This example highlights the subcommittee's findings that foreign countries and their business leaders, especially in cozy regulatory environments, cannot be expected to protect the legitimate interests of the American public. Although the Bermuda government is reportedly planning to raise the capital and surplus requirements for non-captive insurers to more reasonable levels, the

actual effects of such changes will remain shrouded by the cloak of secrecy which characterizes that island's insurance industry.

The Federal Government must take actions to prevent entry into the U.S. marketplace by companies domiciled in countries that harbor and defend deadbeat insurers. Bermuda claims to be the world's third largest insurance market, with more than 1,300 companies collecting $12 billion in premiums annually. Most of that business comes from the United States. However, the Bermuda Fire & Marine case demonstrates quite clearly that, while outside premium money is always welcome in the islands, local interests may not find it convenient to pay their debts.

THE GREAT WALL

The Transit Casualty receivership encountered a different type of barrier in trying to collect reinsurance from the People's Insurance Co. of China. Like Bermuda Fire & Marine, the Chinese company became one of Transit's reinsurers through a broker in London, and eventually was in debt to Transit for more than $20 million on the policies it covered. Also like the Bermuda insurer, the People's Insurance Co. apparently did not want to pay what it owed.

The foundations of the wall erected by the Chinese to avoid payment were delay, additional information requests, and personnel changes. After the Transit receiver was unsuccessful in collecting reinsurance recoverables through traditional methods of notice, billing, and discussions with designated agents, they went to Beijing carrying the data the Chinese company said was needed to settle the claims. Officials at the People's Insurance Co. in Beijing produced a copy of *Failed Promises* to emphasize the wrongdoing which had occurred at Transit, but several days of negotiations only resulted in an agreement to send a Chinese audit team to Transit's headquarters in Los Angeles.

A three-person audit team from the People's Insurance Co. spent 2 weeks poring through the records kept in Los Angeles before returning to China. Thereafter, the Transit receiver was notified that the Chinese company was "switching negotiating teams." The prospect of restarting the whole process with new negotiators having no prior background drove the Transit receiver to commence arbitration proceedings, and the Chinese insurer finally agreed to an undisclosed financial settlement.

The People's Insurance Co. is controlled by China's communist dictatorship, and in such circumstances is not regulated by an independent supervisory agency. The company has reportedly been eyeing the opportunity to do more business in the West. Last year, the chairman of the People's Insurance Co. said "we would like to enter the U.S. market" if that is allowed. Operating as an unlicensed reinsurer through the London market, the Chinese company failed to meet its obligations in this country until considerable extra time and resources were spent by the Transit receivership, leaving less money to pay claims. The subcommittee will closely monitor any attempts to let the People's Insurance Co. enter the United States without the necessary safeguards being in place to protect American claimants.

MR. MIRO GOES TO WASHINGTON

One of the featured case studies in *Failed Promises* was the exploits of Carlos Miro. His 15-year career in the insurance business was a one-man tour of the mechanisms which can be used to get rich by fooling the State regulatory system. It included stints at mainstream brokerage firms and insurance companies where he learned the tricks of the trade. Mr. Miro really hit his stride, however, when he became an unsupervised managing general agent for Transit Casualty Co., and started his first phony offshore reinsurance operation to skim more premiums. From there, he advanced to establishing the Anglo-American Insurance Co. in Louisiana as a self-controlled cash cow to finance his opulent lifestyle. To cover his fraudulent conversion of funds from Transit and Anglo-American, he cleverly created a stable of international shell companies, and used his connections at Lloyd's of London to lend an air of legitimacy to the whole affair.

Failed Promises described all of these activities in detail, based on information obtained during the subcommittee's investigations and testimony from the State-appointed receivers for Transit and Anglo-American. While third-party testimony and documentary evidence provided a solid factual account, Mr. Miro's personal insight was missing because he had fled to Great Britain and Spain to escape the subcommittee's inquiry. That deficiency was corrected on May 19, 1993, when he finally came to Washington, D.C. to tell his story at the subcommittee's public hearing. Mr. Miro appeared as a convicted felon on temporary leave from Federal prison, where he is serving several years after pleading guilty in 1992 to 16 counts of fraud.

As might be expected from someone who conned a fortune, Mr. Miro was a colorful and voluble witness regarding his escapades over the years. He freely discussed the methods he used to cheat the insurance system, and he identified the people who helped him along the way, whether knowingly or not. His primary message was that he had little trouble illicitly reaping millions of dollars in the two cases investigated by the subcommittee, and that it would be fairly easy for him to do it again because business and regulatory standards are so lax. He said finding helpmates for his enterprises was never a chore, as long as he produced a stream of premium cash for them to share and they could plausibly deny actual knowledge of any wrongdoing.

Mr. Miro's testimony caused a stir among the regulatory officials and mainstream businesspeople he accused of being greedy participants or incompetent spectators in the dirty deals he pushed. In their view, nothing he said was believable because he is a proven con artist. The subcommittee warned Mr. Miro that any lies while under oath would be forcefully prosecuted, and checked the details of his allegations with its own records and with the Federal investigators who thoroughly debriefed him. No discrepancies were found, and the objective evidence supported his account of the events which transpired.

The fact that Mr. Miro has lied in the past and been caught does not mean his corroborated views have no value, particularly when they shed light on ugly practices observed by the subcommittee

which more respectable people have denied or ignored. Many of the practices he described could only be told by someone who has already admitted hustling the insurance markets in London and the United States. Moreover, his multi-year success in plundering premiums clearly shows he did not operate alone in the numerous deals he completed that were obviously suspicious or too good to be true. Mr. Miro did not create the insurance system or its loopholes, but he was very adept at seizing the golden opportunities they both offered him.

IT TAKES ONE TO KNOW ONE

Carlos Miro was well-travelled, literally and figuratively, through the insurance markets and regulatory systems in the United States, the Caribbean, and London. Along the way, he met many people and developed real skills in crunching numbers and talking the arcane language of the international commercial insurance world. The following are a sampling of the salient points made by him regarding certain institutions and people during his testimony before the subcommittee:

(1) **State Insurance Regulation.** Calling State insurance regulation a "50-piece puzzle" where "nobody has got a big picture," Mr. Miro said the present system was no serious impediment to his business schemes. He confirmed that State authorities had never taken any regulatory or law enforcement actions against him during his career. When asked if he could use surrogates to start yet another insurance operation in the United States, he replied, "Yes, sir." Mr. Miro contrasted ineffective State efforts to stop wrongdoing with the real fears caused by Federal criminal penalties.

(2) **State Government Corruption.** The testimony included several allegations of criminal activities by State officials relating to insurance supervision and licensing. A significant portion dealt with the bribes paid by Mr. Miro to a "consultant" in order to get the Anglo-American Insurance Co. licensed in Louisiana and Georgia very quickly with bogus capital. The consultant, a political crony of the Governor and insurance commissioner in Louisiana at that time, was paid $100,000 to "grease two commissioners." The State insurance licenses were issued as promised, but Mr. Miro did not witness actual bribes being made. In response to his inquiry about it, the consultant coldly told Mr. Miro "he banked his money, paid his taxes, and what he did with the cash he withdrew was his business." The former Louisiana commissioner was subsequently convicted on Federal corruption charges with Mr. Miro's cooperation, and there are ongoing criminal investigations of the events and persons described in his testimony to the subcommittee.

(3) **Making A Third Attempt At Insurance Fraud.** In 1989, while living in London to evade the legal aftermath of his Transit Casualty and Anglo-American frauds, Mr. Miro planned a third spurious insurance operation to be conducted in the United States. He reached agreement in principle to acquire two small insurers licensed in Louisiana and Wyoming, and intended to use them with another fake Irish reinsurance company to run the same fraud which worked so well at Anglo-American. The deals were not com-

pleted, however, and the two insurers went bankrupt a few months later. The subcommittee asked what happened to prevent this third effort in a 10-year period. Mr. Miro said he was "real close" to completing the transactions, but he hesitated to proceed when he learned the subcommittee had recommended to the U.S. Attorney General that he be criminally prosecuted. He remarked that it was "an interesting question" why he was not stopped by State insurance regulators, and added: "Frankly, if it probably was not for the subcommittee's scrutiny, I would have another Louisiana insurance company right now and no one would know it."

(4) Teaming With Attorneys To Commit Fraud. Mr. Miro employed the services of two outside attorneys, one in Dallas and one in London, whom he accused of being his active accomplices and mentors in committing insurance frauds. He described his Dallas attorney, J. Albert Kroemer, as his "most valued business confidant" whom he consulted "several times a day" regarding illicit plans. Although Mr. Kroemer was a former Federal prosecutor, he allegedly advised Mr. Miro about bribing State officials and dodging prosecution by remaining in London. He also was said to have lied to a Federal court and the subcommittee to conceal Mr. Miro's whereabouts and phony deals, as well as participating in sham transactions himself. Responding to the question of Mr. Kroemer's awareness of criminal acts, Mr. Miro commented, "Al did not just fall off the turnip truck." He clarified the response by answering "sure" when asked if the attorney was a co-conspirator.

The attorney in London, Melvyn Stein, was described by Mr. Miro as his "international lawyer." According to the testimony, Mr. Stein devised the complicated corporate structure that hid Mr. Miro's identity and assets, including anonymous Panamanian holding companies and Swiss bank accounts that were so effective they precluded Mr. Miro from getting access to his own stolen money. Mr. Stein allegedly concocted four non-existent reinsurance companies in Ireland, which he called a "real find" because it was a tax haven and a "respectable sounding" European Union country with "zero regulation" of non-Irish insurance risks. It was claimed that he introduced Mr. Miro to the concept of invoking the attorney-client privilege as a great way to disguise transactions and launder illegal funds, and that Mr. Stein's law firm account was indeed used for that purpose. Mr. Miro summarized by saying that if he was characterized as a bank robber, Mr. Stein "drove the getaway car."

Both Mr. Kroemer and Mr. Stein are presently awaiting trial on Federal criminal charges relating to their dealings with Mr. Miro and his companies. Mr. Miro is cooperating with the Federal prosecutors in those cases.

(5) The Advantages Of Using Fronting Arrangements With Foreign Reinsurers. His rapid success as an independent managing general agent was no surprise to Mr. Miro: "The reason we produced so much business so quickly was through our own aggressive marketing, coupled with Transit's 50-State license and A-rating combined with the mystique of Lloyd's of London standing behind us." He explained that some insurers were "perfectly content" to rent their licenses in fronting arrangements, and that, for offshore

reinsurers, fronting presents "a very easy way to just backdoor your way into the U.S. insurance industry without any regulatory scrutiny."

Agreeing that there is no system for regulating foreign companies, Mr. Miro said it was "shocking" that the process is so simple to get an insurer like Transit "to front for your own rinky-dink offshore captive in the Cayman Islands or the Turks and Caicos or wherever." He recommended that foreign reinsurers should be supervised the same as domestic reinsurers, saying there is "nothing magical about being from another country" to make a company more solvent. Mr. Miro concluded, "You would not permit a foreign bank to do business in the United States on an unfettered basis, why a reinsurance company?"

(6) Lax Foreign Regulation. The relaxed attitudes of foreign insurance regulators were highlighted when Mr. Miro was asked if he had observed official corruption in other countries similar to what he had seen in Louisiana. He replied: "Really, amazingly enough, I do not think there is as much corruption in the sense that they just do not want to know. You do not have to pay them to cover up things, because they never want to uncover them to begin with."

(7) The Roles Of Brokers And Agents. Mr. Miro strongly believes there is a "brain drain" of talented people from insurance companies to independent brokerage firms and managing general agencies because the financial and creative rewards are far better. He also alluded to the camaraderie among brokers in networking sales as an important factor in his success. As former employees of the Alexander & Alexander brokerage firm, Mr. Miro and his colleagues received 60 percent of their business from "the loyal following" he developed during "my A&A whiz-kid days." They actually considered their operation to be "an A&A satellite" because of the close relationship, and he still feels pangs of loyalty to his early mentors who "were like surrogate fathers and uncles to me."

Describing brokers as "the catalyst for whatever is done," Mr. Miro said they were "under pressure to perform" to generate commissions. Even the most ethical brokers, "while they will not lie, they will color the truth every which way they can" to convince underwriters to accept a deal. Asked if brokers should be made absolutely liable for the quality of the business they place with insurers, Mr. Miro said, "Sure." Regarding the use of managing general agents, he expressed his general wariness by commenting that, as an ex-MGA, he never permitted such arrangements when he established his own insurance companies.

(8) Doing Business With Lloyd's Of London. Admitting that reinsurance participation by Lloyd's of London had always provided an illusion of legitimacy to his flim-flam operations, Mr. Miro explained that he first learned about churning commissions on his 1979 trip to Lloyd's. He said it was "a real eye-opening experience" to see how the "real pros" did it: "My first noteworthy recollection of this London market initiation was how expert Lloyd's brokers were at churning the same dollar of premium and 'raking off' a commission as the 'retail' or direct broker, then again by reinsuring the policy-issuing insurance company, and, yet again by arranging

the reinsurers own reinsurance program, etc. In many cases, pyramiding these multiple layers of commission to as much as 25 percent of the gross premiums, if not more." Mr. Miro testified that he told his superiors in Dallas about this "neat trick," and started doing it himself.

Doing business at Lloyd's was never a problem as long as Mr. Miro paid his premiums on time. He said Lloyd's "swallowed everything we sent their way, only asking some token questions now and then." On the reinsurance he arranged for Transit Casualty, Mr. Miro was "surprised" at the lack of inquiry by his broker, John Gimblett, and leery of his tactics. Nonetheless, he went along when the broker "trotted me out" to confuse the Lloyd's underwriters with a complicated high tech sales presentation that was "totally alien to the quill-and-scroll types in London." He elaborated, "All this was part of Gimblett's strategy to have me appear to have beamed in from the spaceship Enterprise and distract them from asking substantive questions." When asked if Lloyd's brokers were essentially conning the underwriters, Mr. Miro replied, "They would refer to it as clever broking, but yes, in a word, yes." He said the underwriters tolerate it due to a "good old boy network," and the brokers are careful not to "kill the golden goose."

For his reinsurance arrangements on Anglo-American, Mr. Miro testified that the Lloyd's broker, Mark Cooke, knew about the bribes and fraudulent nature of the business in Louisiana, but handled it anyway because it was very profitable for him. According to Mr. Miro, this broker was also ready to arrange the Lloyd's reinsurance cover for his third attempt to establish a fraudulent operation in 1989 until it was aborted by the subcommittee's investigation. The relationship with Mr. Cooke was so fruitful that there was mutual talk of having Mr. Miro gain a hidden financial interest in the broker's agency at Lloyd's. The parties ceased negotiations before any agreements were reached.

Mr. Gimblett and Mr. Cooke are still active brokers at Lloyd's, and Mr. Cooke derives approximately 90 percent of his business from the southeastern region of the United States. In separate interviews with the subcommittee, both men denied Mr. Miro's accounts of their dealings, and said they would never deal with him again. However, Mr. Miro believes he could go back to Lloyd's, remarking, "I am sure I could get a handful of acquaintances in London that would probably be happy to front for me as far as any placements into the Lloyd's market."

(9) Becoming A Member At Lloyd's. Mr. Miro said he became an investing member of Lloyd's in 1983 at the invitation of his broker, John Gimblett, who suggested it would be good for doing business there. Apparently, no background checks were made because the chief executive at the brokerage firm knew Mr. Miro was a "good pay" on his reinsurance premiums for Transit. The Lloyd's financial means test was so anemic that Mr. Miro questioned his membership agent about it: "I even asked the gentleman from Linden how do you confirm whether somebody does have these means or not, and he was taken aback and said, well, we presume you're a gentleman or we wouldn't have asked you to join."

The subcommittee inquired about the difficulties, if any, of meeting the Lloyd's requirement that a banker, accountant, or lawyer

certify that a membership applicant truly satisfies the wealth standards. Mr. Miro replied that it was no problem as long as the appropriate professional fees are paid. Asked if Lloyd's required regular checks or annual audits of his wealth, he responded, "Oh, no, not at all." He added that the primary concern was assuring a letter of credit was posted and renewed to cover the 30 percent premium income deposit required from each member.

Mr. Miro said he was told by an agency representative that it would be "prudent" for him to resign his Lloyd's membership in 1990, after he was featured in the subcommittee's *Failed Promises* report. The representative explained that the "powers that be" had read the report, and felt they must take action against him, even though the report was "over the top." His participation as an investor at Lloyd's ultimately cost him about $60,000, even with the benefit of the stop-loss coverage he purchased to protect himself.

(10) Getting Away With His Frauds. In response to the question of how he managed to fool the insurance regulatory system for so long, Carlos Miro answered that "the sad thing is I really did not have to fool anybody" because there were so many people who wanted a piece of the action.

PARTNERS IN CRIME: MESSRS. WINING AND SCHONACHER

Another unfinished story from *Failed Promises* was the insurance adventures of James Wining and Willie Schonacher. These two partners bilked Mutual of Omaha for $225 million during the 1980's, using their uncontrolled managing general agency in Kansas City, Missouri and some phony offshore shell companies domiciled in the Caribbean. In 1987, they also started the dubious Laramie Insurance Co. in Wyoming. Their business operations fell into decline when persistent investigations and civil litigation by Mutual of Omaha proved they were shams, and the Federal Government began looking into their affairs for possible criminal fraud.

The Federal investigation of Mr. Wining and Mr. Schonacher took some odd turns as it evolved. It languished at the Department of Justice in Washington, D.C. for so long that the statute of limitations expired on their major violations. Fortunately, a resourceful Federal prosecutor in Kansas City regained control of the case after the Washington office refused to act, and he succeeded in obtaining prompt indictments of Mr. Wining and Mr. Schonacher on lesser charges. Those indictments finally led to their guilty pleas in 1992, as well as a remarkably lenient sentence given to Mr. Wining by a Federal judge.

Mr. Schonacher apparently quit his bogus insurance activities in 1990, after the pair's businesses were dwindling under the exposure of the civil litigation judgments and the Federal criminal investigation. Mr. Wining, however, continued to be active in pursuing insurance deals and making new contacts until he entered his guilty plea and agreed to cooperate with the Federal authorities in March 1992. Incredibly, Mr. Wining sought to bargain information on his continuing fraudulent activities in exchange for a lighter sentence from the Federal court. The attorney for Mr. Schonacher complained to the court that his client was being unfairly penalized

because he behaved properly after being caught, and thus had no leverage to bargain for a reduced sentence. Although the effect of these arguments on the sentencing judge is unknown, the Federal court ordered Mr. Schonacher to prison for 2 years, while letting Mr. Wining remain free on 5 year's probation to care for his troubled son who might otherwise be institutionalized for his own transgressions.

Controversy continued to surround Mr. Wining during his 2-year period of extended wrongdoing after the Mutual of Omaha case ended his partnership with Mr. Schonacher. He was one of the people involved in bribing the Wyoming insurance commissioner, which resulted in the commissioner's 1990 conviction and 15-month prison sentence on Federal corruption charges. The Laramie Insurance Co. also went bankrupt in 1990. Mr. Wining escaped punishment in both of these situations, and kept his counterfeit career alive with new ventures.

Getting a new start in the insurance business was not difficult using the loopholes in the State regulatory apparatus. Although the details of his fraudulent escapades with Mutual of Omaha and the $225 million judgment were well-publicized in the Kansas City metropolitan area, Mr. Wining simply crossed the river into Kansas on January 2, 1990 to apply for an agent's license in that State. The Kansas Insurance Department issued the license to him in February with no noticeable inquiry into his notorious background. After the Kansas City media reported the incongruity of granting Mr. Wining an agency license, the Kansas department hurriedly revoked it in June 1990.

More ominously, Mr. Wining began a relationship in March 1990 with another insurance entrepreneur named Ferrell Travis Riley. Mr. Riley had a lengthy career of his own in running flimsy companies and moving among State jurisdictions. Having personal experience in domiciling phony companies offshore, Mr. Wining advised Mr. Riley about the benefits of locating an insurance operation in the Dominican Republic. The relationship between them must have grown, since the evidence shows that Mr. Riley continued using the services of Mr. Wining until 1992, and even lent him $50,000 to help with his criminal attorney's fees. Mr. Wining is now inactive and living in a trailer park while on probation, but Mr. Riley is living in a $7,000 per month rented mansion in Kansas City, where he is deeply involved in several insurance-related businesses.

THE LIFE OF RILEY

The insurance business activities of Ferrell Travis Riley came to the subcommittee's attention through its investigation of James Wining. While Mr. Wining was being investigated for his crimes in one case, he was busy networking into a different set of questionable deals controlled by Mr. Riley. The public policy issues surrounding this unholy alliance needed to be examined. Consequently, the subcommittee requested that the GAO's Office of Special Investigations research Mr. Riley's background, and provide an analysis of his insurance ventures and the response of State regulatory authorities. The following narrative highlights the GAO's findings. Through his attorney, Mr. Riley refused the sub-

committee's invitation to provide his own account of the topics described in this report.

Mr. Riley has a record with State insurance commissions dating back to 1984 in Texas, where his failure to file required premium reports went unpunished. His first noteworthy effort centered on an insurer in Houston named Dexter Lloyds. He allegedly participated in issuing unauthorized bonds and misappropriating premiums as an agent and part-owner of the company. In 1985, Mr. Riley devised a plan to gain control of Dexter Lloyds by purchasing its holding company with a $600,000 loan from a friendly banker. He successfully took control in February 1986, which resulted in a majority of the Dexter Lloyds business being conducted through his family-owned agencies. The Texas State Board of Insurance never approved of the takeover, and was not even aware of it because Mr. Riley was not listed as an officer or director of the insurer itself. The Texas Board ultimately put the company under State supervision in August 1986, and into receivership in 1988, but only after its assets had been plundered through numerous manipulated transactions.

With the Texas regulators on his trail, Mr. Riley moved his business operations to Louisiana. He and his associates established the Louisiana Underwriters Insurance Co. in 1987 with a $1.7 million loan from a Texas bank to meet Louisiana's capital requirements. There was no loan agreement or collateral to secure the loan. The $1.7 million was disbursed through 17 separate $100,000 cashier's checks that were deposited in 17 different Louisiana financial institutions. After Mr. Riley received his company's insurance license, the borrowed funds were returned to the Texas bank.

His longtime friend and business associate, Cheryll Coon, was installed as president of Louisiana Underwriters Insurance Co., and Mr. Riley became the company's consultant who made the operating decisions. He was not listed as an officer or shareholder and was not paid a salary, but his generous expenses were paid with company money through Ms. Coon's personal accounts. These included a $200,000 trip to Monte Carlo by the two of them, in addition to $50,000 for rugs, paintings, vases, and sculptures. An examination by the Louisiana Insurance Commission in 1988 found evidence of misappropriated company funds, and it was thus time for the Riley operation to move again. One day before the Louisiana Commission could seize the liquid assets of Louisiana Underwriters, the remaining $800,000 was transferred to Wyoming.

In Wyoming, the Riley team incorporated Meadowlark Insurance Co. in August 1988. Using the same routine, Ms. Coon and other associates became the company's officers, while Mr. Riley was again a consultant. The Wyoming insurance commissioner, later sent to jail for corruption, gave formal approval for Meadowlark to write excess and surplus lines insurance for property, casualty, and marine transportation in the State, even though the company was not properly licensed in any jurisdiction. Although she was representing both sides of the deal at the time, Ms. Coon brazenly petitioned the Louisiana receivership court in 1989 to let Meadowlark assume the assets and liabilities of their former company, Louisiana Underwriters. Amazingly, the court permitted it because Meadowlark promised to pay all policyholder claims.

After legal repercussions from the previous ventures in Texas and Louisiana began to surface, a Wyoming insurance official advised Meadowlark to keep a low profile by not writing new insurance. Mr. Riley and his associates formed the M & M Management Co. and the Magnolia Acceptance Finance Co. around that time to manage the business and finances of Meadowlark. Following the familiar pattern, Ms. Coon became the titular head of these companies and Mr. Riley became the consultant. Although they share space and personnel, these companies are claimed to be separate operations.

The Riley team apparently decided in 1989 to domicile Meadowlark in a foreign country beyond the reach of State insurance regulators. To overcome an admission requirement in certain States that alien insurers have several years of experience, they bought a dormant shell corporation named Arabian Additives Ltd. that had been incorporated in the Turks and Caicos islands in 1982. The company's name was changed to Meadowlark Insurance Co. in the Turks and Caicos, but it was never legally licensed as a Turks and Caicos insurance company. However, purchasing the shell company provided Meadowlark with an instant 7-year history for qualifying as a surplus lines carrier in States which do not ask too many questions. In May 1990, James Wining assisted Mr. Riley in forming Meadowlark Insurance, S. A. in the Dominican Republic as a corporation, but it also was never licensed as an insurance company.

All of the Riley-connected companies moved to Albuquerque, New Mexico in 1989, and sought to be recognized as a surplus lines insurance operation there. Although the New Mexico Insurance Commission refused, Meadowlark did at least $1.6 million of business in other States without authorization. When New Mexico started to examine the company in March 1990, Mr. Riley's lawyer boldly asserted that Meadowlark was not subject to any State's jurisdiction because it was an alien company. Furthermore, he said it was not transacting insurance business in New Mexico because it was selling to residents of other States. The Riley team left New Mexico in 1991 after the State passed a special law to clarify that Meadowlark was not a qualified insurer.

The next destination was Kansas City, Missouri. The Missouri Department of Insurance had received complaints of unauthorized insurance sales in 1990, and had already obtained an injunction in June 1991 prohibiting Meadowlark from transacting business in Missouri. Nonetheless, Meadowlark Insurance Co. and M & M Management Co. moved their offices to Kansas City in August 1991. The State of Missouri does not seem to prevent a company located within its jurisdiction from selling insurance in other States.

In another move, the Riley team apparently succeeded in taking control of the financially-troubled Town and Country Fire and Casualty Insurance Co. in Hutchinson, Kansas. Mr. Riley met with officials at the Kansas Insurance Department in early 1991 to arrange financial assistance for the ailing insurer. Kansas regulators agreed to let Meadowlark and M & M Management Co. provide $400,000 to Town and Country, pending further investigation and approval of their acceptability as controlling parties. Although the

investigation raised concerns about Mr. Riley's influence, his companies had by then made Town and Country solvent by providing funds totaling $855,000. In April 1992, M & M Management transferred its Town and Country stock to Prairie Star, Inc., a Kansas holding company owned by Ms. Coon. Consequently, Mr. Riley and Ms. Coon still control this Kansas-domiciled insurance company.

Meadowlark changed its identity in late 1991 to become the Commercial Indemnity Assurance Co., organized under the laws of the Dominican Republic. Reportedly, a Dominican attorney who represented Meadowlark is the titular head of Commercial Indemnity, and Ms. Coon is the company's "attorney-in-fact." The Commercial Indemnity financial statements prepared by the M & M Management Co. in September 1991 showed assets of $5 million and zero liabilities.

Mr. Riley, his colleagues, and their companies have also been featured in some recent criminal cases. In 1993, for example, his former attorney and an accomplice were convicted of fraud and money laundering. The M & M Management Co. transferred $300,000 of policyholder funds to the attorney in 1991, which he said was intended for bribing Missouri officials to grant a license to Meadowlark. In a classic case of double-dealing, the attorney and his accomplice decided to keep the money for themselves instead. Both are now serving time in prison for that decision.

A second example involves Meadowlark, which started doing business in Maryland in 1991, and was able to sell surety bond coverage to several self-insured transportation companies without a State insurance license. Despite a law requiring that insurers bidding for surety bond business must be approved by the Maryland Insurance Commission, Meadowlark became the insurer for busing school children, the handicapped, and senior citizens in Baltimore. In September 1993, the manager of the Maryland Motor Vehicle Administration's self-insurance program was criminally convicted of accepting a $17,000 bribe from Meadowlark in exchange for steering over $400,000 of premiums to the unlicensed insurer. While the manager was being investigated, Mr. Riley paid his fare to Kansas City, put him on the payroll for more than $2,500 per month, and paid his attorney's fees.

According to recent reports, Mr. Riley, the M & M Management Co., and Magnolia Acceptance Finance Co. maintain their operations in Kansas City, just a few blocks from the National Association of Insurance Commissioners. While Mr. Riley and his business activities are being investigated yet again by Federal and State authorities, the fact remains that he and his associates are still actively involved in the insurance industry. Prior State and Federal attempts to stop them have been unsuccessful.

SENATE SOLVENCY INVESTIGATIONS

The subcommittee notes that parallel insurance solvency investigations and public hearings in the U.S. Senate have produced an extensive record that also reveals monumental fraud and mismanagement in several areas of the insurance industry. The Senate record was compiled by the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, which has actively pursued these issues since 1990. The Senate subcommittee

found severe problems involving fraudulent life insurance operations, renegade managing general agents, bogus offshore reinsurance, and dangerous fronting arrangements. The Permanent Investigations Subcommittee also examined glaring management incompetency and resulting solvency problems at several of the Nation's Blue Cross and Blue Shield health insurance plans.

The Senate subcommittee found that weaknesses in the State insurance regulatory system were permitting the abuses it observed. This subcommittee reached the same conclusion during its 5-year investigation. As Congress and the public consider potential changes in the system for regulating the solvency of insurance companies, the hearings, reports, and findings of this subcommittee and the Permanent Investigations Subcommittee provide solid and complete factual records regarding the problems which must be addressed.

PART III

FOREIGN INTRIGUE

Global competition and multi-national insurance deals are challenging the capabilities of regulators in all countries where solvency is given serious attention. The United States, however, is uniquely vulnerable to the regulatory weaknesses in other countries because it relies so heavily on foreign insurance capacity. The adverse effects of this exposure were illustrated quite clearly in the actual insolvencies investigated by the subcommittee. Those cases also showed that correcting domestic regulatory weaknesses will not be enough if American policyholders are relying on foreign-regulated companies that are unable or unwilling to pay their fair claims.

The impact of foreign insurance regulation on the United States cannot be overlooked. In 1992 alone, policyholders in this country paid more than $8.4 billion in premiums to foreign reinsurers, and also purchased substantial amounts of direct insurance coverage from companies located in other countries. Data collected by the NAIC shows that 83 nations, from Algeria to Yugoslavia, served as the home base for companies participating in the American market.

Foreign ownership of insurers and reinsurers based in the United States is also common, as seen in recent years at such well known insurers as Equitable Life, Fireman's Fund, and the former Executive Life Insurance Company. Although foreign-owned subsidiaries licensed in this country are fully subject to State insurance regulation, the business activities of their parent companies domiciled around the world are beyond the reach of regulators in the United States. Moreover, the bulk of foreign companies providing insurance and reinsurance here are neither licensed nor reviewed by State regulatory authorities or the NAIC.

Limited jurisdiction and resources have precluded even the most conscientious State regulators from obtaining necessary information about foreign entrants into their markets. Absence of a direct regulatory capability means that authorities in the United States must rely upon regulators in many other countries to monitor the solvency of companies providing a substantial portion of the insurance purchased by American policyholders. Premiums generated in the United States reached $482 billion in 1990, which was 35 percent of the $1.3 trillion world total. Although by far the world's largest insurance market, the United States is unique among major nations in its substantial dependence on foreign insurers and reinsurers which flock to get part of the premiums generated here.

Despite their importance to the U.S. market, foreign regulatory procedures and findings have heretofore remained somewhat shrouded in mystery. Since much is unknown about foreign compa-

nies and their regulation, State regulators can only hope for the best. Unfortunately, hoping for the best has left the State system accepting the worst in many situations. The key factors contributing to this situation are inadequate public reporting by alien insurers, different accounting and valuation standards, home market protectionism, and the penchant of foreign regulators for operating in secrecy. In addition, the overwhelming diversity of so many cultures and legal systems has made attempts at useful comparisons among them seem fruitless.

The subcommittee decided to conduct its review of foreign solvency regulation directly by collecting and analyzing factual information provided by the NAIC, the General Accounting Office, and foreign regulators themselves. Such documentary information was augmented through extensive meetings and discussions with business and regulatory officials from Great Britain, France, Germany, Belgium, Ireland, Luxembourg, Guernsey, Australia, and the European Commission. The subcommittee's inquiry revealed a number of striking similarities among foreign regulators with respect to their basic methods and attitudes which substantially affect the United States.

CAVEAT EMPTOR

An effective system of international solvency regulation should encompass open availability of important information regarding the soundness of insurers, as well as meaningful solvency standards, adequate monitoring procedures, and cooperative enforcement. The broad range of foreign regulatory systems observed by the subcommittee falls far short of those goals. Instead, it reveals a hodgepodge of conflicting rules, with little cooperation among different nations. Protecting insureds in the United States is clearly not one of the primary concerns of regulators in other countries.

Consequently, American insurance companies and policyholders should be wary of purchasing foreign coverage based on jurisdictional reputation alone. The maxim "buyer beware" can fairly be applied even to some of the nations generally considered to be the most sophisticated commercially. Comfort may be taken from an individual company's demonstrated financial strength, but relying upon foreign regulatory vigilance to catch problem companies is often a shaky proposition.

One reason is that other countries are more inclined to intervene directly and cushion their citizens from the harmful effects of insolvent insurers. Large insolvencies, like those seen in the United States, rarely reach public attention because governmental assistance minimizes their impact on individuals in order to maintain public confidence in the soundness of insurance products. Foreign insurance markets are also smaller and more tightly controlled. As a result, foreign regulators generally do not envision large-scale failures as a threat which demands their immediate attention, and this attitude shows in their supervision methods.

Regular on-site government examinations of insurance companies is another area where foreign attitudes are different. Unlike the United States, regulators in other countries normally depend upon market tips or referrals from insurance company auditors to detect unsafe practices and wrongdoing. If nothing is reported, the regu-

lators assume that nothing is wrong. Obviously, waiting for an auditor's call or a newspaper report did not constitute appropriate regulatory surveillance in the cases studied by the subcommittee.

Although courteous, cooperative, and patient with the subcommittee's inquiries, foreign regulators routinely expressed an opinion that serious solvency problems could not occur under their systems, and that the subcommittee should restrict its efforts to the United States. Countries having a well-developed insurance market tend to believe their citizens will resist buying from weak foreign insurers offering low-ball prices. They also depend upon responsible behavior from their domestic insurance companies to counteract market predators. Smaller countries appear convinced that unique customs, closely-knit business communities, and national government assistance will protect them from unwanted outsiders.

Most foreign regulators do not face independent public scrutiny, so proclamations of sublime confidence in their abilities cannot be verified. By contrast, the system in the United States is quite open to the public through mandatory company financial reports, ownership statements, civil litigation disclosures, public access laws, and independent governmental audits of regulatory agencies. Oversight by Congress, as a separate branch of government, is also part of the process. In short, the U.S. system is oriented toward publicly disclosing solvency regulation problems, while foreign systems seem more oriented toward avoiding negative publicity.

THE REINSURANCE CHECK IS IN THE MAIL

Measuring the impact of alien reinsurance on the solvency of insurers in the United States was an early concern of the subcommittee. To accomplish this goal, the subcommittee analyzed the 1992 reinsurance data collected by the NAIC in order to assess the payment record of alien companies. The results of that analysis are displayed in Table 1 of the Appendix to this report, entitled *Overdue Reinsurance On Paid Losses Owed To Insurers In The United States.*

Insurance companies licensed in the United States file annual financial reports with the NAIC listing their accounts with foreign reinsurers. In 1991, the NAIC upgraded Schedule F of its annual report form to require disclosure of unpaid foreign reinsurance receivables that are seriously overdue. The maximum overdue category established by the NAIC is for balances that are more than 180 days late, meaning that amounts in that category can range upward from 6 months to indefinitely overdue. Eventually, delinquent reinsurance receivables must be written off as uncollectible debts.

Industry representatives and State regulators have often complained that foreign reinsurers threaten the solvency chain through exceedingly slow claims payments, or failing to pay at all. The subcommittee's analysis provides startling evidence to the truth of those complaints. Table 1 shows that astounding levels of claims payment delinquency are widespread. Counting only those countries with more than 25 percent of their debts over 6 months in arrears, the table identifies 26 countries which collectively owe insurers in the United States a total of $2 billion. Approximately $724

million, or 35 percent of that amount, is approaching uncollectible status. Incredibly, 15 of those 26 countries had more than 50 percent of their debts in the deadbeat category.

A review of 1992 reinsurance premiums demonstrates that failure to pay on time is no barrier to continuing lucrative business in the United States. Twelve of the 26 countries listed in Table 1 received more premiums from the United States in 1992 alone than they owed on all their outstanding claims. For Bermuda, the British Virgin Islands, Canada, the Channel Isles, Norway, and Great Britain, premiums generated in 1992 exceeded their total claims balances by margins ranging from 100 percent to more than 700 percent. Since current premiums have often proven woefully insufficient to cover long-term losses, these statistics could foretell future collection problems of even greater magnitude than those observed for 1992.

The data gathered by the NAIC does not explain why so many countries harbor seriously delinquent reinsurers. However, it is a certainty that the dimensions of this problem are substantially understated by Table 1 because the data only shows reinsurance claims that are due immediately. Amounts in that category are often just the tip of the iceberg, since they are limited to reimbursement requests for claims payments that have already been made to policyholders by insurers in the United States.

The ultimate liability of alien reinsurers also includes IBNR allocations for losses that have been incurred but not yet officially reported to primary insurance companies. In recent times, skyrocketing long-term claims have raised the IBNR component of known losses far beyond the relatively limited amounts already being paid to policyholders who have actually filed claims. Insurers and their reinsurers are required to maintain adequate current reserves for projected IBNR losses, but failure to meet this requirement is both the most common and the most fatal flaw in every insolvency observed by the subcommittee.

Settling reinsurance claims can take 6 months or more during the normal course of business, and negotiating claims occurrences and amounts payable under a contract can add extensive delays to the process. Consequently, reinsurance receivables presently listed in the NAIC's 180-days-overdue category are likely to be at least 1 year or more in arrears. Excessive delays place the primary insurers in a potential cash-flow squeeze while they are waiting to be reimbursed.

Late-payment and non-payment by alien insurers and reinsurers is clearly a serious problem. The NAIC data, though understated, presents a shocking portrait of delinquency practiced on a grand scale by companies domiciled in major foreign commercial centers, as well as those based in developing countries and colorful locales. The subcommittee's investigations of Mission Insurance Co., Transit Casualty Co., the Weavers Stamp companies, and other failures convincingly demonstrate that this area is a very weak link threatening the international chain of insurance relationships.

THE SUBCOMMITTEE'S FOREIGN REGULATION QUESTIONNAIRE

As another part of its efforts to obtain hard information, the subcommittee sent a regulatory information questionnaire on March 5, 1993 to 47 foreign insurance commissioners compiled from a list supplied by the NAIC. The subcommittee's questionnaire contained 60 questions concerning each regulator's organization, resources, legal powers, reporting requirements, enforcement activities, and cooperation with supervisory authorities in the United States. Respondents were asked to complete the questionnaire as best they could, and return it to the subcommittee by April 16, 1993. The subcommittee sent follow up letters on May 13, 1993 to each of the foreign commissioners which had not yet responded. Through September 1994, 37 of the 47 agencies receiving a questionnaire had returned a completed copy to the subcommittee.

Countries were selected to receive the subcommittee's questionnaire on the basis of NAIC report data showing their gross reinsurance business transacted with companies licensed in the United States. As might be expected, most of the polled countries are either major U.S. trading partners in Europe and Asia, or Caribbean island nations favored as regulatory and tax havens. For example, Bermuda and Barbados ranked in size with Great Britain, Germany, France, Switzerland, Japan, Canada, and Sweden as major reinsurance sources.

Although designing a brief questionnaire to measure regulatory effectiveness is difficult, the subcommittee succeeded in obtaining comparable data for the key categories affecting solvency regulation in the United States. The subcommittee very much appreciates the effort and cooperation demonstrated by those insurance commissions providing current information on their regulatory activities. A complete listing of the 47 questionnaire recipients and the 37 respondents is shown in Table 2 of the Appendix under the heading, *Responses To The Subcommittee's Foreign Regulation Questionnaire.*

QUESTIONNAIRE RESPONSES AND FINDINGS

The subcommittee's questionnaire and related investigation show four common attributes shared by the regulatory commissions surveyed. First, insurance regulation in other countries is focused almost exclusively on domestic market considerations. Second, foreign regulators do not routinely examine insurance companies directly. Third, the relationships between insurers and their affiliated companies are not scrutinized very carefully; and fourth, foreign regulators operate autonomously, and do not cooperate well with each other or with regulators in the United States. These general findings are not surprising, because they correspond with the causes of insolvencies documented in the subcommittee's case studies. Foreign insurance regulators also seem largely content with their methods and resources, and none of them appear overly concerned that companies based in other countries might seriously damage their domestic markets.

Responses to the subcommittee's questionnaire from most foreign regulators revealed weaknesses that are similar to problems found

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in the U.S. regulatory system, such as insufficient authority, resource limitations, poor monitoring, and low solvency standards. In addition to these, quite a few nations fail to regulate reinsurers or refuse to make adequate information available to the public. The subcommittee tabulated and compared the questionnaire responses in five key areas of interest to the United States.

(1) Lack Of Cooperation

Ten countries failed to provide any response at all to the subcommittee's original and follow-up inquiries. Those countries are Antigua, Argentina, Bahrain, Brazil, Cayman Islands, Greece, People's Republic of China, Romania, Taiwan, and Uruguay. Regulators from the Cayman Islands contacted the subcommittee on May 5, 1993 to say their response was forthcoming. It never arrived. The letter to Greece was sent to an address provided by the NAIC, however, subsequent conversations with officials of the European Union divulged that Greek regulators were located at a different address. No response has yet been received to a duplicate request sent to the new address on November 16, 1993.

Taiwan had not responded to the subcommittee's two request letters by June 1993, when a subcommittee staff representative had a chance encounter with the Deputy Director of Taiwan's Department of Insurance at the NAIC meeting in Chicago. The Deputy Director's business card confirmed that the Taiwan address used on the subcommittee's letters was indeed correct. Nonetheless, the subcommittee made yet a third effort by faxing the questionnaire to the number printed on the Deputy Director's card. Eventually, the second letter mailed to Taiwan came back to the subcommittee marked, "Return To Sender, Moved, Left No Address." No further word has been heard from Taiwan.

The failures of Argentina, Brazil, China, Romania, and Uruguay to return the questionnaire are significant because they all rank in the top ten among nations with seriously delinquent reinsurance recoverables owed to the United States. At least 65 percent of their debts were more than 6 months overdue as of year-end 1992, according to NAIC data. By comparison, Taiwan looks relatively wholesome with its number 22 ranking and one-third non-payment rate.

Among the 37 countries which answered the subcommittee's questionnaire, the response from Barbados illustrates that cooperation was not always willing or complete. In his cover letter, the insurance commissioner emphasized that Barbados is a sovereign state, and said:

> I found it unusual that your committee seeks to gather such detailed information on our insurance regulatory framework without going through the normal diplomatic route.... It is not clear to this office why you intend to list foreign insurance regulators who fail to provide the requested information.

The Barbados commissioner's focus on diplomatic protocol was matched by his zeal in applying that tiny nation's secrecy requirements. More than one-third of his response to the sub-

committee's general information questionnaire was left blank, citing secrecy laws. Beyond mere words, this episode highlights the subcommittee's concerns about attitudes and practices in other countries wanting to do business here. The United States must obviously identify such uncooperative countries, and establish safeguards against known weaknesses in order to protect its domestic markets.

(2) Secret Regulation

The subcommittee asked regulators in the survey if they are prohibited by secrecy laws from sharing criminal and regulatory information with foreign government officials, particularly those in the United States. Thirteen respondents said they were covered by some form of secrecy law. Because of difficulties in interpreting the provisions in other countries, however, this number understates the scope of the secrecy problem among respondents.

For example, the European Union's uniform directives generally prohibit the sharing of information with foreign regulators outside the Union after July 1, 1994. Member States are permitted to negotiate information sharing agreements with outside supervisory agencies only if the country in question has a comparable confidentiality provision. European officials are not sure how this applies to the United States, where no Federal agency is authorized to negotiate such an agreement, and State governments lack authority to enter into treaties with other nations.

European Union member States gave varying replies to the secrecy law question. From a U.S. perspective, however, all the European Union member countries are covered by secrecy laws, because they operate under a common requirement for a negotiated cooperation agreement with outside countries. There is obviously no basis for negotiating with the United States until a Federal agency is appointed to handle this assignment.

At least 24 of the 37 countries answering the subcommittee's questionnaire are affected, to a greater or lesser degree, by secrecy laws. These laws are a major obstacle preventing international cooperation, but they are only part of a much greater bias toward isolated regulation. Table 3, *Foreign Secrecy Laws And Disclosures To Regulators In The United States,* displays complete results of the secrecy law inquiry.

Absence of a formal secrecy law does not necessarily equate with regulatory cooperation. A realistic working arrangement requires open communication channels, mutual trust, and resource commitments. These elements have all been sorely lacking in the cases examined by the subcommittee, and the questionnaire responses show that the problem is widespread.

The subcommittee asked respondents how many times they have disclosed information to regulators in the United States since January 1, 1987, as well as how many times such disclosures have been requested. Their answers, presented in Table 3, represent the sum total of regulatory information exchanged between 50 State regulators and 37 foreign countries over a 6 year period. Twelve foreign regulators had zero re-

quests and zero disclosures over that period. Four stated that no data or statistics were available. Five regulators answered "N/A", while seven more answered by placing a dash in one or both of the response blanks. Barbados and Italy did not respond to the question at all.

This leaves only seven countries, out of 37 respondents, that both exchanged information and had some idea about the frequency. Four of these countries supplied specific numbers: Australia with three, Ireland with ten, the British Virgin Islands with two or three per week, and Turks and Caicos with "at least 100" disclosures. The remaining three gave verbal descriptions: Great Britain reported "several" requests and "several" disclosures; Guernsey had "several" requests and "countless" disclosures; and the Isle of Man reported "a number" of requests and disclosures.

The subcommittee also asked alien regulators to describe their procedures for providing information about insurance companies and their operators to regulators and law enforcement agencies in the United States. Among 37 respondents, only 6 mentioned the NAIC as a contact point in answering the questionnaire. Portugal mentioned the NAIC hypothetically as the entity it might deal with if an information sharing agreement could be reached. Australia cited "Contact with the NAIC or directly with the relevant State Commissioner." Venezuela said it discloses information "upon request of the interested agency members of N.A.I.C." The Isle of Man referred to the NAIC "network", while the regulator from Guernsey mentioned the name of a part-time NAIC consultant as the contact person for the United States. The regulator from Hong Kong "has established communication channels with the NAIC and various U.S. regulators for the exchange of information which would be of mutual interest."

Of the 31 responding countries that did not mention the NAIC, nine either failed to respond or said they have no formal procedures. Another nine cited secrecy laws or regulatory restrictions on information. Most of the remaining 13 offered descriptions that were brief or vague. For example, Canada's response to this question was: "We will respond to formal requests from other regulators."

The subcommittee concludes there really is no commonly recognized communications system between insurance regulators in the United States and foreign countries. In some countries, implacable resistance to mutual cooperation for political and competitive reasons appears quite obvious. However, many regulators interviewed or responding to the questionnaire do not seem hostile to better communications. In particular, the reaction toward building mutual assistance channels is generally positive among the major trading nations in Europe, although there is little enthusiasm expressed for initiating the procedural details needed to accomplish such a large project.

Lack of prior interest and experience, combined with formal secrecy laws, are the biggest obstacles to international regulatory cooperation. Clearly, the United States must be the driving force in overcoming these impediments because it has the

market influence and the most to gain, due to its considerable foreign exposure. All responsible nations will benefit from surmounting regulatory isolationism, but it will take commitment and effort to get the ball rolling.

(3) Invisible Insurers

A phenomenal number of foreign regulators permit, or even encourage, invisible insurance companies. These insurers and reinsurers are licensed to sell to the public, but they disclose very little information regarding their ownership, operations, affiliations, and financial condition. Effective regulatory penalties for lying to the public do not exist in most countries, so company managers are basically free to spread whatever information or tales that suit them. Some Caribbean nations actually turn the tables on common sense reporting by having laws to punish people who disclose or inquire too much about invisible companies.

A major purpose of effective regulation is to require that sufficient information is provided to the public by every insurer, not just those which have nothing to hide. Good regulators review the information submitted by companies, correct harmful omissions and misrepresentations, and make sure that management boasting is balanced with accurate factual presentations. The goal is to hold all companies to the same fair disclosure standards. In the United States, public disclosure of essential insurance company information is accomplished through standardized NAIC regulatory filings and reports required under the Federal securities laws. The combination of these two systems far exceeds public disclosures in any foreign country known to the subcommittee. American regulatory weaknesses stem from a lack of monitoring and enforcement of existing reporting rules, as opposed to having disclosure rules which are themselves seriously deficient.

Open disclosure is a cornerstone of the insurance market in the United States, characterized as it is by easy entry, intense competition, and easy exit. Foreign insurers and reinsurers, which are not licensed or regulated in this country, should at least be providing financial and operating information that is comparable to their domestically-based competitors. That reasonable expectation has not been fulfilled under the present State regulatory system.

State regulators have apparently accepted self-serving declamations that the United States would somehow be abandoned if foreign companies were made to meet this country's reporting requirements. Nobody has adequately explained why a multitude of alien interlopers would suddenly leave, or where they would go to replace lost business from the world's richest market. Despite anguished cries bemoaning excessive litigation and unfair claims settlements in the United States, there has been no shortage of foreign insurers eager to do business here. The departure of those unwilling to accept reasonable reporting would undoubtedly alleviate many of the problems in America associated with flimsy capitalization and illusory reinsurance.

The subcommittee measured public access to foreign insurer information through a series of direct questions on that topic. The threshold question was whether regulators were collecting important information for their own in-house supervisory responsibilities. The overall response to this question revealed significant lapses in supervisory information, but these paled in comparison with the mammoth amounts of crucial data that are withheld from the public. Results of the subcommittee's inquiry are displayed in Table 4 of the Appendix, entitled *Availability Of Key Information To Foreign Regulators And The Public*. This table shows a pattern of erratic and incomplete information collection by foreign insurance regulators, as well as an overall low regard for public disclosure. Whether intentional or not, this tattered framework fosters insurer invisibility. Such invisibility creates an ideal environment for the types of management excesses, speculation, and wrongdoing that caused the insolvencies observed by the subcommittee.

Disclosure standards in some countries are ridiculously inadequate in comparison with those in the United States. At least 11 of the 37 respondents do not require that insurers make basic financial statements available to the public. Reinsurance arrangements are withheld by 29 nations, and 22 hide the identities of affiliated companies and their business relationships with insurance companies. In another question, the subcommittee asked whether auditor's reports and actuarial reserve certifications submitted to regulators by insurance companies are available to the public. Fifteen of the regulators responding do not make auditor's reports available to the public, and sixteen withhold actuarial reserve certifications.

The subcommittee also asked whether decisions made by the regulator are a matter of public record. Eleven countries replied that decisions are not made public, and ten others said that regulatory decisions are a matter of public record only under certain conditions. For example, four make regulatory decisions public only if the company is bankrupt, being wound up, or ordered to cease writing business. Barbados declined to respond. The remaining countries, just 15 of 37, replied that decisions are available to the public.

(4) Ignoring Affiliates

The subcommittee's questionnaire included several inquiries about regulatory scrutiny of insurer relationships with affiliated companies. Holding companies are often used to milk cash from insurance subsidiaries for the benefit of other business interests. Transactions with related companies, such as loans, purchases, and management contracts, can also bleed insurer resources through conflicts of interest and insider dealing.

Holding and affiliate company abuses have been a common thread in every insolvency studied by the subcommittee. On paper, the intricate dealings among several jointly-controlled entities can lend an aura of corporate respectability to otherwise sham transactions, but they also help to confuse supervisory agencies. The corporate veil is typically used to thwart legitimate inquiries by alleging that proprietary information of non-related companies is beyond the regulator's reach. Very

few regulators in the United States or foreign countries monitor the routine activities of insurance companies closely enough to detect self-dealing problems. Alerts from independent auditors are also unlikely to disclose them because transactions with related parties are usually structured to resemble normal business activities.

Table 5, entitled *Foreign Regulatory Authority Over Holding Companies And Affiliates,* shows insufficient capabilities in this important area for most overseas insurance supervisors. Nearly one-half of the foreign agencies do not have sufficient access to the records of affiliated companies, and a similar number do not have legal authority to investigate persons or companies controlling an insurer. Even the agencies possessing these powers are unlikely to exercise them due to practical limitations and lack of interest. Some regulators told the subcommittee they do not need to check holding companies and affiliates because they are satisfied that any wrongdoing will be prevented by their firm control over the operations of supervised insurance companies.

More than half of the regulators responding do not require prior approval of related-party transactions. Approximately the same number do not approve dividends made to an insurer's shareholders in advance. Without these safeguards, regulators can only act after harm from insider dealing and excessive dividends has already occurred. Complex holding company and subsidiary relationships are accepted modern business practices, but regulatory scrutiny is needed to verify that related-party transactions are proper. Furthermore, legal authority to pursue questionable dealings among affiliated companies, when necessary, is a valuable regulatory tool.

(5) Unregulated Reinsurance

In *Failed Promises,* the subcommittee called reinsurance the black hole of insurance regulation. That phrase aptly conveyed the vast unknowns about reinsurance arrangements, as well as the overwhelming force of their allure for insurers needing a financial fix. The subcommittee has since found the black hole of reinsurance to be even darker in several foreign countries where there is a complete regulatory vacuum.

The questionnaire explored this void by asking foreign regulators how they supervise reinsurance companies. Most countries replied that they treat reinsurers the same as primary companies, which means reinsurance supervision around the world is characterized by the same loopholes and weaknesses that afflict normal insurance regulation. Going beyond problems with the norm, however, the subcommittee's survey revealed that Belgium, France, Ireland, Israel, and the Netherlands do not license or regulate reinsurance companies at all. Two other countries, Denmark and Germany, conduct some minimal oversight, but the level is so low that reinsurers do not think they are being regulated.

Failure to regulate reinsurance companies is not just an academic concern. Belgium and Ireland were the domiciles for bogus reinsurance operations run by Carlos Miro and others, who used those countries as decoys to swindle premiums and

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fool regulators in the United States. After investigations by Congress, Federal prosecutors finally obtained criminal fraud convictions in those scandalous cases. However, the sad fact remains that Belgian and Irish insurance regulators did not prevent the establishment of such criminal enterprises as legally chartered business entities which were free to export financial mayhem.

Reinsurance risk swings have proven to be far greater than those for primary insurers. Unsound reinsurance arrangements are thus proportionately more dangerous to solvency, yet insurance regulators everywhere retain a pronounced reluctance to involve themselves in actively supervising reinsurance activities. The usual explanation is that reinsurance transactions do not affect the public because they are handled exclusively by professionals, but it appears that many regulators are ill-prepared to handle the demands of reinsurance supervision. Reinsurance is often placed through a complicated international network of brokers and companies that is exceedingly difficult to monitor, so regulators seem inclined to leave it alone.

Overall, reinsurance regulation in other countries displays weaknesses which are similar to those found in the United States. Due to these weaknesses at home and abroad, additional controls will be required to establish adequate minimum supervision of alien reinsurers operating in the United States.

COME TO THE ISLANDS

When it comes to weak and permissive regulation, the most frequent image is a sunny island, with a warm climate and a friendly government that does not ask too many questions. The subcommittee discovered much truth to this popular perception, but regulatory sanctuaries are not just confined to tropical isles. Numerous island and developing nations around the world are competing to attract insurance entrepreneurs.

The concept of government-sponsored havens to serve the needs of companies instead of consumers has become quite fashionable. Insurance-related enterprises have developed a cachet as non-polluting, white-collar businesses that protect natural resources and add to community wealth and prestige. Countries selling themselves as insurance domiciles typically offer tax relief and relaxed supervision in exchange for the outside economic stimulus given to resident businesses. They make no pretenses about attracting insurers to serve local customers, since their domestic markets are limited in size and usually controlled by native insurance companies.

Several foreign countries have even adopted offshore licensing laws to advance their goal of becoming the legal domicile for more non-resident insurance companies. These laws permit specially licensed insurers to sell insurance anywhere except locally. Through such selective licensing, problems of mismanagement and insolvency arising from lax regulation are carefully exported to other countries, particularly the United States. The sole purpose of export licensing laws, which exempt offshore operations from strict regulation, is to promote local community development and commerce at the peril of policyholders elsewhere.

Because safety and soundness are not the paramount goals of special export-insurer licensing, some jurisdictions have carried this concept to the ultimate level of self-regulation by professional management companies. These countries forgo direct supervision of insurers in favor of relying upon professional managers to operate offshore companies and report any problems to government regulators. Practitioners of this trusting arrangement do not appear overly concerned about its inherent conflicts of interest or its adverse effects on victims in distant lands.

Self-regulation is possible because certain government supervisors, especially in the islands, require licensed insurance companies to employ the services of locally-run professional management companies. This scheme provides jobs and income for the home economy, while placing titular management responsibilities with persons in the community known to the regulators. Governmental oversight of professional management companies is said to occur through personal relationships forged during business meetings and social events. Such management companies simultaneously represent both the supervisory agency and the company being supervised, but the fact remains that they are hired, fired, and paid by the company's owners.

Perhaps in response to rising antipathy about lax foreign regulation, the insurance supervisors in 12 countries specializing as export domiciles recently started a new organization to improve their solvency standards and cooperation. They formed the Offshore Group of Insurance Supervisors (OGIS) at the June 1993 meeting of the NAIC in Chicago. Many foreign regulators were gathered there as a result of the NAIC's annual invitation for them to attend one of its meetings, as well as its sponsorship of the newly-created International Association of Insurance Supervisors.

The list of initial OGIS members reads like a "Who's Who" of out-of-the-way islands and countries offering export insurance licenses to outside investors. Criteria for OGIS membership include "acceptable" insurance legislation, effective enforcement, adequate administrative resources, and an ability to exchange information with fellow regulators. The first members were Anguilla, Bahamas, Barbados, British Virgin Islands, Gibraltar, Guernsey, Isle of Man, Jersey, Malta, Netherlands Antilles, Panama, and Turks and Caicos. The Cayman Islands, St. Vincent, and Labuan, Malaysia were granted "observer" status. Bermuda declined to join.

The stated purpose of the new group is "to bring together the insurance supervisors of those territories from within which offshore insurance activities are carried out, and which have established proper, effective regulation . . ." With a nod toward honest self-assessment, the press release announcing formation of the OGIS admitted that all of its initial members may not satisfy its membership criteria, but said they have all shown their intent to do so by June 1996. Nonetheless, the organization promises to develop acceptable standards, provide other insurance supervisors with mutual assistance, and encourage other territories to meet equivalent standards.

The goals expressed by the OGIS are laudable. However, there remains a natural skepticism regarding the intentions and abilities of countries which have harbored well-known insurance pirates,

and which continue to advertise their speed and ease in granting export licenses. As a voluntary membership group like the NAIC, the OGIS must also depend on the consent of its members to implement better standards. The subcommittee will monitor the progress of OGIS members, and look for credible evidence that they will actually shed the secrecy and lax regulation which have marked their insurance-related prosperity. A few doubtful signs have already emerged.

The first proclaimed task of the OGIS was preparing an offshore supervisors manual, with a section outlining the advantages that "well supervised offshore centres" bring to "onshore territories." Based on geography, experience, and its open market, the United States is presumably the most famous and attractive of these "onshore territories." The subcommittee sees no need for further expositions on the benefits of island retreats, where "ours is not to question why" has often epitomized regulatory attitudes. The worthy objectives declared by the OGIS could easily descend into nothing more than a marketing ploy if that path is taken.

Another ominous signal was the appointment of Barbados as the Vice-Chair of the OGIS. That island's secrecy laws are among the most stringent in the world. In responding to the subcommittee's regulatory information survey, the Supervisor of Insurance for Barbados stated in his cover letter: "Section 35 of the Exempt Insurance Act restricts the disclosure of information on a licensee other than that which is publicly available at the Office of the Registrar of Companies. Thus I have completed the questions of your questionnaire which I can so complete."

In fact, the Barbados regulator declined to answer 21 of the 60 questions. The information that he could not or would not disclose included:

- Offshore premium volume, and how much of it came from the United States;
- Number of sanctions issued by the regulator, and whether regulatory decisions are a matter of public record;
- Number of impairments and insolvencies;
- Procedures for rehabilitation and liquidation of insurers;
- Whether Barbados has a policyholder protection fund;
- Procedures for sharing information with regulators in the United States, and the frequency of any such contacts;
- Regulations pertaining to affiliate transactions and extraordinary dividends; and
- Investigatory powers of the regulatory authority.

The limited information actually provided to the subcommittee by Barbados was no more reassuring than its failure to answer such basic questions. Barbados has a special law to license offshore captive insurers, although this law does not appear to govern very much. On Barbados, regulatory authority to examine insurers when necessary, and to see their books and records, is restricted to companies serving its domestic market. The refusal to regulate the solvency of companies operating elsewhere rests upon a conclusion that captives are private companies which pose no risk to the public. Having seen enough examples of captive problems to dismiss such a premise, the subcommittee notes that Coopers &

Lybrand describes the Barbados situation in its International Insurance Industry Guide as follows:

> There is also the Exempt Insurance Act which is dealt with separately under the section on captives, though in fact some of the companies licensed under this Act can no longer be regarded as "captives" as they are writing business extensively to non-shareholders.

The subcommittee has found that pseudo-captive companies can cause substantial harm to the public. As with other solvency problem areas, regulatory oversight of captive companies is necessary before supervisory relief can be justified. Without adequate scrutiny on a case-by-case basis, there is no reasonable basis to grant blanket regulatory exemptions to any insurer that fits a loose definition of "captive."

ISLAND PROFILES

The best way to view the regulatory approach of various well-known island domiciles is to list and compare certain attributes of importance to the United States. The subcommittee has drawn information from its foreign regulatory information survey to highlight key elements in the following regulatory profiles. As the Cayman Islands did not respond to the subcommittee's questionnaire, that haven is not included.

The islands profiled by the subcommittee are the Bahamas, Barbados, Bermuda, British Virgin Islands, Guernsey, Isle of Man, and Turks and Caicos. These domiciles share three characteristics:

(1) Their regulatory apparatus is small and underfunded, relative to the size of the industry they regulate.
(2) Start-up capital and licensing requirements are weak.
(3) Public information is restricted.

In addition, the Bahamas, Barbados, Bermuda, and Turks and Caicos share another important characteristic: secrecy laws.

Regulatory Profile: Bahamas

Note: Insurers that accept risks exclusively from outside the Bahamas are licensed under one of two insurance laws. Single parent captives and association captives who accept at least $500,000 in premiums from their members are licensed under the External Insurance Act of 1983 ("1983 Act"). All others are licensed under the Insurance Act of 1969 ("1969 Act").

Size of Industry	There are 84 insurers domiciled or legally incorporated in the Bahamas. The industry generates over $200 million in premium volume annually.
Size of Regulatory Body	5 full-time Staff
Annual Budget	Could not estimate because budget is incorporated into Ministry of Finance Budget.
Minimum Start-up Capital	1969 Act: $140,000 General $300,000 Life 1983 Act: $100,000 General $200,000 Life
Time to Obtain License	6 Weeks
Secrecy Laws?	Yes, under the 1983 Act
Number of Disclosure to U.S. Regulators Since Jan. 1, 1987	"Not Available"
Public Information	A broad range of information is reported to regulators, but none of it is available to the public. Audit reports and reserve certifications are not available to the public.

Regulatory Profile: Barbados

Size of Industry	There are 222 insurers domiciled or legally incorporated in Barbados. Regulator would not disclose offshore premium volume.
Size of Regulatory Body	12 Full-time Staff
Annual Budget	Could not estimate because budget is incorporated into Ministry of Finance budget.
Minimum Start-up Capital	$125,000
Time to Obtain License	6 Weeks Maximum
Secrecy Law?	Yes. Because of this law, regulator did not respond to over one-third of the Subcommittee's questionnaire.
Number of Disclosures to U.S. Regulators Since Jan. 1, 1987	No Response
Public Information	A broad range of information is reported to the regulator, but none of it is available to the public. Audit reports and reserve certifications are not available to the public. Regulator would not disclose whether regulatory decisions are a matter of public record.
Other	Only $100,000 in financial security is required for direct insurers. No financial security is required for reinsurers. Despite the small staff, regulator claims to examine every insurer every year. This calls into question the quality of the examinations performed.

Regulatory Profile:
Bermuda

Size of Industry	There are 1,363 insurance companies domiciled or legally incorporated in Bermuda. Only 43 of these are licensed to sell in the domestic market. Net premium volume was $11.8 billion in 1991.
Size of Regulatory Body	18 Full-time Staff
Annual Budget	$1.25 million
Minimum Start-up Capital	$250,000 for Life Insurers $120,000 for Non-life Insurers
Time to Obtain License	3 to 12 Weeks
Secrecy Law?	Yes
Number of Disclosures to U.S. Regulators Since Jan. 1, 1987	"N/A"
Public Information	A broad range of information is submitted to the regulator, but none of it is made available to the public, except the companies' share register. Details on the beneficial owners of insurance companies cannot be released. Regulator is prohibited by law from issuing basic financial information about insurers. Audit reports and reserve certifications are not available to the public. Regulatory decisions are confidential, unless a company is being "wound up."
Other	No financial security required for non-domestic risks Despite the relatively small staff of 18, regulator claims to examine every company every year. This calls into question the quality of the examinations performed.

Regulatory Profile: British Virgin Islands

Size of Industry	**Approximately 200 insurance companies are domiciled or legally incorporated in the British Virgin Islands.**
Size of Regulatory Body	**2 Full-time Staff**
Annual Budget	**$120,000**
Minimum Start-up Capital	**$100,000, plus solvency margin based on business plan projections.**
Time to Obtain License	**13 Weeks**
Secrecy Law?	**No**
Number of Disclosures to U.S. Regulators Since Jan. 1, 1987	**Too many to count. Approximately 2-3 times a week.**
Public Information	**A broad range of information is submitted to the regulator, but only the identity of owners and managers is available to the public. Audit reports and reserve certifications are not available to the public.**

Regulatory Profile:
Guernsey

Size of Industry	**250 insurance companies are domiciled or legally incorporated in Guernsey. The industry generates over $1 billion in premium volume annually.**
Size of Regulatory Body	**20 Full-time Staff**
Annual Budget	**$1.5 million**
Minimum Start-up Capital	**$150,000**
Time to Obtain License	**2 Weeks minimum**
Secrecy Law?	**No**
Number of Disclosures to U.S. Regulators Since Jan. 1, 1987	**"Countless"**
Public Information	**A broad range of information is reported to the regulator, but none of it is released to the public. Audit reports and reserve certifications are generally not available to the public. Regulatory decisions are a matter of public record only when an insurer is prohibited from making insurance contracts of any description.**
Other	**When asked about the frequency of on-site financial exams, the regulator stated: "We examine only when considered necessary. The local general representative is obliged to inform us of any material changes in circumstances of the insurer."** **There are no financial security requirements.**

Regulatory Profile:
Isle of Man

Size of Industry	**148 companies are domiciled or legally incorporated in the Isle of Man. The industry generates $3.5 billion in premium volume annually.**
Size of Regulatory Body	**5 Full-time Staff**
Annual Budget	**$400,000**
Minimum Start-up Capital	**$750,000 for Life** **$225,000 for General** **$ 75,000 for Captives** **$150,000 for Reinsurance**
Time to Obtain License	**3-4 Days to 3-4 Weeks**
Secrecy Law?	**No**
Number of Disclosures to U.S. Regulators Since Jan. 1, 1987	**"A Number"**
Public Information	**A broad range of information is reported to the regulator, but none of it is released to the public. Audit reports and reserve certifications are not available to the public.**
Other	**Despite the very small staff, regulator claims to examine every company every year. This calls into question the quality of the examinations performed.**

Regulatory Profile: Turks and Caicos

Size of Industry	There are 1,353 companies domiciled or legally incorporated in Turks and Caicos.
Size of Regulatory Body	7 Full-time Staff, including just one chartered accountant and no actuarial staff.
Annual Budget	$300,000
Minimum Start-up Capital	$100,000 for General $180,000 for Life $100,000 for Reinsurance
Time to Obtain License	2 Weeks Minimum
Secrecy Law?	Yes
Number of Disclosures to U.S. Regulators Since Jan. 1, 1987	At least 100
Public Information	A broad range of information is submitted to the regulator, but only the identity of managers is available to the public. Audit reports and reserve certifications are not available to the public.

THE EUROPEAN UNION: A NEW FEDERAL SYSTEM IN EUROPE

Traditionally, the greatest foreign sources of insurance and reinsurance for the United States are the major countries in Western Europe, particularly Great Britain, Germany, Switzerland, and France. European countries have been working for years to promote competition throughout the continent by removing their various national trade barriers. The leader in this movement is the European Union, with its broad treaty powers binding each of its present 12 member States to a phased-in mutual reduction of restrictive laws and regulations.[4]

The European Union pact specifically outlines a plan for free trade of insurance and other financial services among its members. To achieve that goal, the European Commission in Brussels has issued a series of 21 directives to harmonize insurance regulations in member countries, so that an insurer domiciled in any member State can freely sell its products throughout the Union. When these directives became fully effective on July 1, 1994, an insurer licensed and regulated in one member State automatically gained a passport to operate anywhere in the European Union, without additional regulation by other States.

Essentially, the European Union is creating a Federal regulatory system that depends upon the national insurance regulators in each member State to enforce the general solvency rules established by the central authority in Brussels. Its goals of harmonized rules, mutual recognition, and regulatory cooperation are similar to the NAIC's efforts to develop a national solvency program in the United States. Both programs, however, reflect an attitude that all participants from the insurance industry and member regulatory agencies will demonstrate exemplary behavior in following their uniform standards. History plainly does not validate this utopian ideal.

In its switch to multi-state regulation, the European Union starts with two significant advantages. First, the European Union has been granted legal authority by its member nations to establish mandatory rules that its 12 national regulatory agencies must follow. Second, its member States are legally required to recognize and accept insurance companies licensed by other member nations. These are indispensable elements of unified regulation that are absent in the United States, and are beyond the reach of the NAIC.

On the negative side, European nations have deeply rooted differences in language, culture, and laws, as well as a strong tradition of protecting their domestic markets. The U.S. benefits from a common language, a unified constitution and legal system, and more than 200 years of experience in working together under its Federal Government. Even so, the gradual development of multistate regulation has not gone smoothly in this country.

The importance of several European Union nations as alien insurance providers means that policymakers in the United States must pay attention to regulatory changes there which affect American policyholders and claimants. The subcommittee is concerned

[4] The 12 current Member States are: Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, and the United Kingdom.

that dropping national solvency controls will encourage weak companies and unscrupulous operators to domicile their insurance businesses in member countries where supervision is most lenient. From there, they can market themselves across the European Union, and ultimately to buyers in the American market.

THE GAO'S EVALUATION

To address its concerns, the subcommittee asked the General Accounting Office (GAO) to evaluate the new European Union regulatory framework, and identify potential areas that could impact the United States. The GAO reviewed existing legislative directives, standards, and market studies, and also interviewed regulators and industry representatives in Great Britain, France, Germany, Italy, and the European Commission in Brussels. The GAO's analysis and findings were presented in its August 1993 report entitled, "European Community: Regulatory Issues in Creating a Single Insurance Market," (GAO/GGD-93-87).

The GAO observed that the European Union is taking bold steps toward deregulation while crucial policy questions remain unanswered. These unresolved issues fall into three groups: (1) Regulatory procedures which still need to be addressed; (2) Continuing regulatory differences that will not be harmonized; and (3) Uncertainties about how successfully some regulatory elements will be implemented. The report raises serious doubts that the Union will be able to avoid the pitfalls experienced by regulators in the United States.

The GAO says European Union officials recognize the importance of resolving the first group of issues in order to establish a single market. Additional measures to address them are being considered, such as a proposed directive to assure equal treatment of policyholders and creditors in all member nations when an insurer is liquidated. Union officials also plan to implement minimum qualifications for agents and brokers, and review the adequacy of solvency margins and financial conglomerate supervision.

The second group of issues deals with regulatory differences which the Union has no plans to harmonize. These differences involve taxation, contract laws, valuation methods, supervisory reporting, and antifraud measures. Officials at the European Commission told GAO that these areas do not require harmonization, and are adequately covered by existing procedures. However, the GAO notes that prior attempts to harmonize some of these differences were abandoned after they proved too difficult to resolve.

The third set of issues reflects uncertainties regarding how some of the most important new regulatory practices will work after July 1994, when they were implemented. These issues include cross-border supervision of insurers by home State authorities, regulatory cooperation arrangements, resource availability, enforcement criteria, and even how the term "insolvency" will be defined. The GAO reports that European Union regulators are developing mechanisms they believe will successfully make the single market concept work in practice.

The GAO report on the European Union's single market deregulation scheme highlights several remaining key differences and unresolved issues that could undermine the program's success. Some

regulators and industry sources in Europe doubt the new framework will work as intended, but most seem either willing or unconcerned about giving the plan a try in order to gain the financial benefits of an open market. After reviewing the report, the European Commission vehemently defended its efforts, and criticized the GAO for being too negative.

THE IMPACT OF THE EUROPEAN UNION'S DEREGULATION ON THE UNITED STATES

In the United States, there is a haunting familiarity to the GAO's cautionary message about the problems which accompany deregulation. Promises of wondrous benefits to consumers, industry, and government abounded when the savings and loan industry was set free in the 1980's. Safety precautions were tossed out with the regulators' rulebooks, and anyone warning about the predictable and dangerous consequences was viewed as a gloomy financial Luddite. The result of this national departure from prudent supervision was the $180 billion taxpayer bailout of the savings and loan industry by the Federal Government.

The subcommittee's own inquiry confirms the GAO's observations about market deregulation within the European Union. As full implementation of the program begins, there is general optimism regarding its reliability and competitive benefits among the program's administrators and most participants. There is also an apparent and quite natural difference in viewpoints between the rulemakers in Brussels and the member State regulators who must implement the rules. Making new rules is much easier than making them work in practice, yet even the rules are incomplete.

For example, the issue of regulating reinsurance companies remains unresolved. Six countries in the European Union—Belgium, Denmark, France, Germany, Ireland, and the Netherlands—do not presently regulate these companies. While the central administrators in Brussels are looking for progressive action by individual countries on this issue, the Belgian regulators told the subcommittee they are waiting for a uniform directive from the European Commission to be developed. They want the ultimate requirements settled before spending the time and effort to deal with reinsurance regulation.

Enforcement actions against insurers licensed in other member States is another potential problem area. The uniform directives require that an insurer's home State regulator supervise its business activities throughout the European Union. However, the authority of regulators in other member States to stop harmful practices within their own jurisdictions is limited if the home State supervisor fails to act. Individual regulators openly profess their trust in the competence and diligence of fellow European regulators, but several expressed some private anxiety to the subcommittee. Two insurance supervisors told the GAO they would not guarantee the soundness of policies issued by insurers based in other member States, since they would not be responsible for supervising those companies.

Credible solvency programs should not be built upon improbable assumptions which disregard the hard lessons taught by financial adventurers in the real world. The problems inevitably associated

with multi-state regulation in a Federal system are well known in the United States, where forum shopping to find the weakest regulator is a long-standing debility. To diminish these problems, the NAIC's solvency accreditation program relies upon periodic accreditation reviews to measure compliance by its member States. There are no proposals for independent compliance evaluations in the European Union framework, indicating that each national regulatory agency will be left to judge for itself whether it is conforming with the Union's rules. Consequently, free market entry by insurers within the Union could become a contentious issue if individual national regulators favor local companies or harbor unprincipled speculators.

The European Union and its member States are embarking on a deregulation scheme which, in order to succeed, will demand the highest levels of altruism, trust, cooperation, and cross-border vigilance from individual national regulators. Although the Union's scheme is still largely untested, experience in applying similar principles in the United States has not been successful. Furthermore, individual European regulators have not previously displayed these qualities in cases studied by the subcommittee. Policymakers in the United States should keep these factors in mind when formulating appropriate rules to monitor alien insurers and reinsurers.

LLOYD'S AND THE LONDON MARKET

From an American viewpoint, the subject of foreign insurance usually begins and ends with the London insurance market, and Lloyd's of London in particular. This focus is based upon the real importance of London as the central international marketplace for buyers in the United States. Additionally, the London market's popular reputation has been buttressed and embellished for many years with exaggerated perceptions and outright mythology. To the extent that such myths contribute to foolhardy behavior, they should be dispelled.

Many Americans, even some in a position to know better, erroneously believe that any insurance coverage purchased in London is somehow associated with Lloyd's, and that all insurance placed with Lloyd's is guaranteed not to fail. They envision Lloyd's as a giant insurance company, possessing near perfect skills and knowledge, that backs every policy with its unlimited financial pledge. In this rosy vision, buying insurance at Lloyd's evokes quaint English traditions reminiscent of British Empire grandeur, such as liveried footmen ringing the Lutine bell.

Certainly, market traditions developed over 300 years, combined with an enviable reputation for always paying claims, have imbued Lloyd's of London with a unique franchise value, confirmed through official recognition by the British government. Brokers representing Lloyd's have readily used its respected reputation over the years to sell insurance and investments to a willing public in the United States. Lloyd's image as the cradle of insurance and an invincible financial behemoth has been enhanced further through its highly-visible participation in American insurance policy-making and regulation.

In effect, Lloyd's presence in the United States has far exceeded its actual size as a commercial entity. Its influence and mystique have, in turn, been powerful enough to cause American misperceptions about Lloyd's to be extended to the entire London insurance market. Unhappily, this confused generalization about Lloyd's and the London market induced a series of miscalculations and unwise business decisions by insurance buyers and investors in the 1980's. The painful fallout greatly hurt both the public and the London market. It even affected Lloyd's and many of the market insiders who previously benefitted from misplaced idealism about the organization's infallibility.

In reality, the London market for international insurance is divided between coverage placed with companies licensed by British government regulators, and policies placed with Lloyd's of London, which has been granted statutory legal authority to regulate itself. There are approximately 130 London-based companies involved in writing international insurance and reinsurance, and many of them are subsidiaries of large insurers domiciled in Europe, Japan, and the United States. Like all licensed insurance companies, their financial strength depends upon publicly-reported assets and income that are regulated by the British government. Statistics from 1992 show aggregate net premium income over $5 billion attributed to these companies, accounting for 36 percent of the London subscription market.

The remaining 64 percent of the market is held by investor syndicates at Lloyd's that had aggregate net premiums exceeding $9 billion in 1992. Contrary to popular belief, Lloyd's is not a single insurer placing its entire financial resources behind every policy. Instead, it is a self-regulating market organization, with centralized solvency rules and security arrangements, operated by its scores of member syndicates for their mutual benefit. Lloyd's sponsors and regulates an organized trading market for its members, much like the New York Stock Exchange does for the securities firms constituting its membership.

Lloyd's pioneered the concept of coinsurance, where a single policy can be backed by several insurance syndicates in order to spread the risk accepted by each one. Although many syndicates may participate in coinsuring a specific policy, they are separately responsible for their individual shares of any losses that occur. Thus, policyholders must look to the solvency of each participating syndicate of individual investors in order to measure the total claims-paying ability behind insurance policies issued through Lloyd's.

The financial solvency of each Lloyd's syndicate depends upon the personal solvency of its individual members. Until recently, Lloyd's steadfastly held to its traditional twin requirements for investor membership: Only real people can be members, and they must promise to pay insurance claims with every asset they own, "down to their last cufflinks." This archaic concept of unlimited personal liability was finally modified by Lloyd's in 1993 regarding future membership, but it governs all past policies issued through the organization.

To guard its reputation against non-payment of claims, Lloyd's assesses its members in order to maintain a central solvency guar-

antee fund. This fund, valued at $1.3 billion on December 31, 1993, has been adequate in the past for protecting Lloyd's as an organization from the inevitable failures of some investors to pay what they owe. However, traumatic events and monumental losses at Lloyd's have seriously challenged its overall solvency reputation during the past few years, and increasing amounts have been charged against the central solvency fund.

LONDON CALLING

A key to Lloyd's lengthy success as a market where almost any risk can be underwritten is an extensive network of brokers, who find insurance buyers and funnel their business to London. Insurance brokers call on commercial clients throughout the United States, seeking to place their policies at Lloyd's or in the London company market. From there, the same business can be shared or reinsured with foreign companies domiciled in Europe, Asia, North America, South America, and a host of island-states. The London-based company market has flourished by following Lloyd's example of specializing in coinsurance of extra-large or hazardous risks that are hard to insure elsewhere.

London's appeal as a market also derives from its unique concentration in one location of insurers and reinsurers from all over the world. Combined with a vast local community of brokers and intermediaries who can arrange general or special coverage, they provide one-stop shopping for commercial insurance buyers. Negotiating terms and finding a suitable number of insurers or reinsurers willing to share the risks offered by a particular buyer is much easier in such a concentrated marketplace.

During the 1980's, Lloyd's became victimized by its own success when the organization's unique strengths began to work against it. The sizeable army of Lloyd's brokers and underwriters, famous for their individualism and creative solutions, was not controlled by any central management scheme. Using Lloyd's sound reputation to gain personal competitive advantage, they oversold its risk-taking abilities to their clients and to themselves. In essence, Lloyd's permitted thousands of individual entrepreneurs to market its special franchise, with each one claiming to represent Lloyd's regarding the merits and details of particular policies.

Sales in the United States benefitted from a general American belief in the financial stability of Lloyd's, and also from misunderstandings concerning its arcane workings. For example, loose talk about the $9.6 billion Lloyd's American Trust Funds, held by a New York bank, led many people to believe that it provided joint security for any unsatisfied claims originating in the United States. Those trust funds are really structured as separate accounts to manage premiums, denominated in U.S. dollars, that are paid to individual Lloyd's brokers by their clients around the world. There is no legal right to attach the total amount of the Lloyd's American Trust Funds in order to satisfy a single unpaid claim.

Misleading titles were also confusing to Americans. Carlos Miro, later convicted of fraud, identified himself as an "underwriting member" of Lloyd's to bolster his image with potential clients in the United States. In truth, he was just an outside investor with no underwriting authority. Mr. Miro was technically correct in his

assertion, however, because Lloyd's permitted its passive investors to use the term "underwriting member" to describe their association with the organization. This subtle distinction was surely lost on many of his customers in Louisiana and Georgia who were impressed by Mr. Miro's alleged status at Lloyd's.

WHEEL OF MISFORTUNE AT LLOYD'S

The tremendous success of Lloyd's and the London market provided the foundation for recent problems which have threatened the market's future. For many years, easy capacity and generous income bred complacency, loose management, hands-off regulation, and a pervasive attitude that the London market was immune to serious failure. These negative trends were fueled by popular myths and unchecked rumors that infected the judgments of insurance buyers, market insiders, and investors.

Problems began at Lloyd's in the 1980's, when its gross underwriting capacity tripled to $15 billion, and its total number of individual investors almost doubled to more than 32,000 people. To support a pledge of unlimited personal liability for paying claims, each investor was required by Lloyd's to demonstrate personal wealth exceeding $150,000 (later raised to $375,000). In practice, this goal was rather easily satisfied through certification by an accountant, a banker, or even a lawyer. Wealth could be based on the home equity value of an investor's residence, and only 30 percent of each investor's anticipated premium income was required to be deposited at Lloyd's.

The public's perception of Lloyd's as an elite and somewhat aloof organization, with rich customs and still richer patrons, created a powerful draw for those selected to join. Aggressive recruiting in Great Britain, the United States, and around the world reaped hundreds of new investors possessing relatively modest wealth. Most were flattered to be chosen, and all were eager to share in the profits generated at Lloyd's. The traditional face-to-face meeting, where Lloyd's management confronted each new investor with his or her unlimited personal financial exposure, was considered by many to be a pro forma ritual signifying an event that would never happen.

In such an environment, it was considered impolite for outside investors to question too closely the activities of Lloyd's insiders who magically produced the profits. Probing questions were often not clearly answered, or were dismissed with an attitude that made investors feel ignorant and ungrateful. The lure of Lloyd's membership was best summarized for the subcommittee by one investor who said: "What group, other than Lloyd's, could convince a bunch of moderately well-off dentists in Canada to pledge their entire fortunes to an organization in London, sight unseen?"

The additional underwriting capacity drawn to Lloyd's in the 1980's was not soundly managed by its inside underwriting agents. The finite amount of sound business that traditionally produced the most profits at Lloyd's was already subscribed, so new capacity was too often used to underwrite high-risk business that profited market insiders at the expense of outside investors. Such overly speculative underwriting resulted in enormous unanticipated losses that busted many syndicate members. Part of these losses were

caused by commercial excess and surplus lines coverage for asbestos and pollution claims in the United States, and some were caused by certain Lloyd's syndicate managers unwisely insuring the poor underwriting of other Lloyd's syndicate managers.

The deleterious effects of excessive capacity, extravagant underwriting, and weak capital led to rapid growth and record losses that brought Lloyd's to the brink of collapse by 1993. Due to the delay caused by its 3-year accounting cycle, the organization finally revealed this year a massive deficit of $3 billion for its operations in 1991. This enormous loss followed previous deficits of $3.5 billion for 1990, $3.5 billion for 1989, and $984 million for 1988. Obviously, there is much anxiety about the size and effect of losses yet to be reported for 1992 and beyond.

A large number of Lloyd's outside investors have said they are unable or unwilling to pay their share of gigantic claims that dwarf their original investments, and even exceed their total wealth. Calling themselves "deficit millionaires", because Lloyd's is demanding payment of millions they never had, many have banded together to challenge the legality of such payments. They charge that insiders controlling Lloyd's intentionally misrepresented the safety of its investment practices, and deliberately fleeced outsiders by concentrating their investments in the worst syndicates bearing the highest risks. Personal bankruptcy, as well as despair over ever escaping Lloyd's dogged pursuit of their last assets, exacerbate the anger and betrayal felt by estranged investors, and some have tragically committed suicide.

Although Lloyd's as an organization has statutory immunity from legal challenges, individual underwriting managers and member's agents are apparently liable for damages to outside investors who can prove fraud or gross negligence. Reportedly, 17,000 outside investors—about half of the peak total reached in the 1980's—are involved in litigation proceedings seeking more than $5 billion. These damage claims will be handled under British law, but they cast a shadow over current efforts to make Lloyd's profitable in the future. In addition, the bulk of any damages may fall heavily on the Lloyd's market, because errors and omissions insurance coverage for underwriting managers and agents is largely maintained within Lloyd's.

LOOKING TO LLOYD'S FUTURE

A radical new business plan and management structure were introduced at Lloyd's in 1993. Centralized monitoring of individual underwriting and investment practices was instituted, and market management powers are now divided to avoid obvious conflicts of interest and unfair insider dealing. There are also plans to start an in-house reinsurance company called NewCo, which is expected to assume all Lloyd's outstanding liabilities prior to 1986. The purpose of NewCo is to "ring-fence" future operations of the reorganized Lloyd's from the debilitating drain of ongoing losses from excessively bad business underwritten in the 1980's.

The success of these efforts to save Lloyd's depends upon a large-scale infusion of new capital from limited-liability corporate investors to underwrite future business. Reportedly, $1.3 billion was subscribed from corporate investors by year-end 1993. In addition

to their money, Lloyd's central management is hoping those investors will bring added professionalism to the Lloyd's marketplace. While recruitment of corporate capital seems to be going well so far, serious questions still face Lloyd's regarding the long-term commitment of corporate investors, adequate funding for NewCo, and negative fall-out from litigation among its members.

It is too early to judge whether Lloyd's bold new business plan will evolve an old institution into a modern organization which can successfully handle both its past and its future. The freshly-installed management at Lloyd's insists that fundamental inside changes and demonstrated outside investor interest have combined to meet the challenge, while critics maintain that Lloyd's current efforts are based on yet more wishful thinking. However, there are already positive signs that the organization is shedding some of its harmful myths. For example, solvency ratings by Standard and Poor's now recognize the financial condition of each Lloyd's syndicate as a separate entity, rather than lumping them together under the illusion of a single insurer with united resources.

When the subcommittee began its solvency inquiry 5 years ago, nobody even questioned the financial viability of Lloyd's of London. Clearly, if such major problems can strike so quickly at the heart of this venerable institution, it reinforces the need for urgent reforms in solvency regulation affecting insurers and reinsurers with far less resilience. Lloyd's has long been an important insurance market for policyholders in the United States, and the subcommittee welcomes all serious attempts at restructuring the institution to meet the solvency problems set forth in this report.

JEOPARDY IN THE COMPANY MARKET

The pattern of troubles afflicting Lloyd's in the 1980's also struck the London company market for international insurance and reinsurance. This comparability is not surprising, considering those companies modeled their practice of coinsuring commercial risks brought to them by independent brokers upon the Lloyd's system. Moreover, London-based companies shared business with syndicates at Lloyd's, and they operated in the same libertine market environment, where the push for "can do" coverage was fueled by "sign on" fever.

Many London insurance companies became hooked on reinsurance magic. Like their American counterparts at Mission, Integrity, and Transit Casualty, underwriting managers and brokers in London became convinced that purchasing reinsurance simply relieved them from any future obligation to pay exorbitant claims. The attraction of reinsurance as an absolution for speculative underwriting was encouraged by its easy availability and affordable pricing.

Quota share reinsurance was a popular method for sharing the business written by another insurance company. In return for a fixed percentage of premiums, the reinsurer agreed to pay a fixed percentage of the losses incurred on one or more insurance policies written by the originating company. Unhappily, this automatic sharing arrangement also meant that a reinsurer could quickly and uncontrollably ratchet itself into enormous losses if the first company exercised poor underwriting judgment.

The London Market Excess of Loss (LMX) cover was an additional manifestation of the specious belief that financial disaster could be avoided by paying part of the premium to transfer hazardous insurance risks elsewhere. As a marketing tool, the LMX designation cleverly employed a high-tech acronym to describe a refined-sounding concept. Its real effect, however, was passing the buck, both literally and figuratively.

The sensible theory behind excess of loss coverage is to cap an insurer's exposure if gross losses exceed specified levels. For a fee, other insurers agree to cover cumulative losses that reach catastrophic proportions. It is an accepted and prudent business strategy when risks are properly spread and adequately priced. The LMX fad neglected both of these worthy goals.

The popularity of LMX and quota share reinsurance united to create a spiral of mutual insurance relationships in the London market. The same risks circulated around the market to be shared again and again among the same group of participants. When heavy claims payments began ascending through the spiral, a substantial number of London-based companies and Lloyd's syndicates were unable to handle the strain because leftover premiums, depleted by too many roll-over commissions, were insufficient to cover constantly rising claims.

Ironically, excess of loss coverage and quota share reinsurance are intended to reduce an insurer's financial exposure by spreading risks among different participants. Instead, they became tools for concentrating and confining unbearable financial losses within the limited capital base of the London market. The market wizards behind this reverse alchemy—turning premium money into fool's gold—preached an alluring notion of risk-free profits today, in return for transmitting the costs of tomorrow's catastrophes around the trading floor or across town.

The London version of uncontrolled managing general agents, called independent underwriting agents, were a dominant force in selling the concept of large-scale LMX and reinsurance coverage to willing customers. Viewed as a harmonious convergence of minimized loss exposure and maximized commission income, such coverage became the realm of market specialists, who could not get enough of a good thing. The worst of these became hucksters, who joined forces with other disciples of P.T. Barnum in the United States to cause unprecedented international havoc.

Objective evaluations of the London insurance market are hard to find because much information is unavailable, and most information sources are also market players. Standard & Poor's Insurance Rating Services, however, provides independent financial research and analyses for measuring the solvency of insurance companies and individual Lloyd's syndicates. The Standard & Poor's findings confirm that solvency is a matter of growing concern in the London market.

According to Standard & Poor's, financial stress in the London market has been particularly acute in recent years, reflecting a concentration of high risk business and remarkably low capitalizations for many insurers and reinsurers. Twenty percent of the 130 companies trading there in 1981 were considered "vulnerable," and constant wastage resulting from insolvencies, cessations, and run-

offs left only 88 of those same companies active in 1991. At year end 1990, new additions kept the total number of London market companies at 134, but the number of companies rated "vulnerable" in 1991 remained constant at 20 percent. During the 10 years from 1981 to 1991, at least 58 companies withdrew from the market for one reason or another.

Analysts at Standard and Poor's point to harmful effects of the LMX cover and the reinsurance spiral as causes for weakness in the London market. They also blame problems on a deadly combination of huge claims, relatively small companies, and a history of inadequate reserving. Standard & Poor's concludes that the difference between strong and weak companies will widen in the next few years, as the London market continues to play a major role in the global insurance market. The ratings organization recommends a high degree of care in choosing London-based insurers and reinsurers in order to assure adequate financial security.

BRITISH REGULATORY RESPONSE

Insurance companies licensed in Great Britain are regulated by a division of the Department of Trade and Industry (DTI). The DTI issues licenses, promulgates financial and ownership reporting requirements, monitors solvency, and exercises enforcement authority when considered necessary. In general, the DTI possesses all the powers held by State insurance commissioners in the United States, plus a few extra ones relating to independent investigations and debarring chronic management offenders. The agency also loosely supervises self-regulatory efforts at Lloyd's through its annual solvency certifications made to the DTI.

Regulatory procedures in Great Britain have far-reaching effects on policyholders and claimants in America, because London is the focal point for collecting premiums and paying claims for international insurance and reinsurance. With approximately one-third of its domestic commercial business placed offshore, the United States is London's biggest overseas customer.

In addition, British influence on insurance regulation extends to several island insurance domiciles that are associated with Great Britain as territories or Commonwealth members. These include Barbados, British Virgin Islands, Bermuda, Cayman Islands, Turks & Caicos, Guernsey, Isle of Man, and Hong Kong. As regulators, such countries are guided by British legal principles, and some are headed by British citizens. Bermuda and Barbados are very important foreign domiciles for companies doing business in the United States, and some of the islands with British ties have served as harbors for skullduggery by modern-day insurance pirates.

Recognizing the importance of British insurance regulation to the American market, the subcommittee made special efforts to communicate with both Lloyd's of London and the DTI. The purpose of these efforts was to promote mutual understanding about solvency regulation, and to explore methods of cooperating to combat serious problems observed by the subcommittee. Much has been learned through several cordial exchanges over the past 5 years, but the subcommittee has encountered distinct limitations on information sharing and enforcement cooperation involving the British government.

Lloyd's has been cooperative in its dealings with the subcommittee. With strong customer and investor ties to the United States, Lloyd's has a clear interest in working to resolve solvency weaknesses which have dearly cost both the public and the Lloyd's market. Threats to its existence caused Lloyd's to reorganize itself in 1993, and to seek an infusion of new talent and resources. Although just starting, Lloyd's has firm plans to de-mystify its operations through corporate management techniques and more public information.

Results at the DTI are less encouraging. Government legal restraints hinder its ability to cooperate with the subcommittee and regulatory officials in the United States. In addition, there are fundamental differences in approach between efforts in the United States to achieve effective solvency regulation and efforts at the DTI to meet the same goal. Whereas Lloyd's confronted its solvency problems directly with hands-on reorganization and more access for investors and customers, the DTI is guided by a hands-off philosophy. Typically, the DTI depends upon insurance company auditors or market complaints to uncover solvency problems. If nothing is reported, the DTI confines its routine supervision to reviewing insurer financial reports filed with the agency.

The primary solvency tools used by DTI are its powers to review an insurer's business plan, and also to determine whether senior officers and directors are "fit and proper" to perform their duties. These checks are done whenever a company is started or there is a change in management control. The DTI has discretionary authority to reject business plans and officers considered to be unsound, however, the agency's decisions must rely on factual evidence rather than opinions in order to satisfy government legal procedures.

Actuarial certifications and independent audits are required to be submitted to the DTI annually by licensed insurance companies. Although these tasks are performed by private firms employed by company managers, the DTI is confident from its experience that this system is reliable. The agency also notes that most insurance activities are centered locally in London, and its officials believe that serious problems could not remain hidden for long within the community.

Independent underwriting agents, brokers, intermediaries, and management companies are not regulated by the DTI. Any problems they cause would be addressed through reviewing their business relationships with regulated insurers if suspicions arise. The DTI prefers to exercise its powers quietly and indirectly with questions that are intended to discourage unsuitable practices.

NO HANDS ACROSS THE SEA

The subcommittee has attempted several times through correspondence and visits to establish official information exchange channels on regulatory and enforcement matters affecting Great Britain and the United States. The British government's response has been, at various times, a polite recitation of DTI's public procedures, disinterest in the subcommittee's findings, and confident expressions that "fit and proper" monitoring of the London market is a successful deterrent against wrongdoing. The subcommittee's in-

vestigations do not confirm the sanguine views of British regulators.

Procedures followed by the DTI in regulating the KWELM companies illustrate some of the significant differences between the agency's approach and the subcommittee's findings. Officials at DTI told the subcommittee that the KWELM companies had inadequate records and internal controls, yet those known deficiencies apparently went unreported and uncorrected. Despite DTI's monitoring system, the unregulated Weavers Underwriting Agency was given management control over the KWELM companies through an agreement that was said to be only one-half page long.

Reports filed with DTI by the KWELM companies disclosed their premiums and claims payments, but did not reveal the underlying high-risk business strategy concocted by Weavers. Substantial under-reserving at the KWELM companies was compounded because DTI permitted present-value discounting of reserves for future liabilities. No early warnings were sounded by the independent auditors employed by the companies, and no actuary was involved in setting reserve levels until the DTI encouraged management to get an independent actuarial review in 1989.

According to the DTI, the agency had suspicions about the solvency of the KWELM companies, but it took time to develop enough evidence to warrant regulatory action. Evidence was obtained by questioning company managers regarding the content of their annual reports to DTI. When asked if the $5 billion collapse of the KWELM companies indicates weak regulatory procedures, DTI officials responded that the KWELM failures represent problem individuals rather than problems with the system.

Unsuccessful attempts by the subcommittee to corral the elusive Carlos Miro while he resided in London further demonstrate problems in dealing with British authorities. The subcommittee sent letters on September 20 and October 4, 1989 to the British ambassador in Washington, D.C., informing him about Mr. Miro's participation in causing two major insurance company failures in the United States. The letters warned that Mr. Miro was almost surely living in London, that he was probably using a fraudulent Mexican passport, and that he likely was still running insurance businesses. The subcommittee also described how its efforts to obtain Mr. Miro's financial records were blocked by his London attorney, and requested information and mutual cooperation from British authorities in stopping Mr. Miro.

The British ambassador replied to the subcommittee by letter of November 30, 1989. He said that Mr. Miro was not in Great Britain, and that no investigations of his business activities were planned. The ambassador's letter included some public data regarding ownership of Mr. Miro's flagship insurance holding company in London, Anglo-American Trust Company, and mentioned that the company was thought to be the parent of insurance companies operating in the United States. The British ambassador assured the subcommittee that Mr. Miro could only be involved with an insurance company in Great Britain if he were notified to the DTI, and found by that agency to be "fit and proper."

Mr. Miro was indeed residing in London at the time of the subcommittee's alert to the British government. He was actively oper-

ating insurance businesses and transacting fraudulent deals affecting the United States. He effectively avoided British insurance regulation by restricting himself to running holding companies, management companies, and offshore reinsurance companies. Commendable persistence by the Louisiana liquidation receiver for Anglo-American Insurance Company eventually unraveled Mr. Miro's financial web in London, which was centered around his British attorney. Federal law enforcement authorities finally extradited Mr. Miro from his last residence in Spain, and he pled guilty to Federal criminal fraud charges in 1992.

Mr. Miro testified before the subcommittee on May 19, 1993 as a convicted felon serving a Federal prison sentence. When asked about the British ambassador's letter, Mr. Miro said it was "somewhat humorous" to read that he was not in Great Britain while he was sitting in his London office. He claimed to have entered that country legally, after completing its immigration forms. He also confirmed that he was never investigated by British authorities, and stated that it was "pretty simple" for him to operate in foreign countries.

The subcommittee's experience with Great Britain demonstrates substantial difficulties in obtaining foreign assistance to halt international wrongdoing. Lack of cooperation in pursuing Carlos Miro and the Weavers Stamp operation is most disturbing. In those cases, key operatives used London as a haven to exploit the U.S. insurance market, and elude legitimate inquiries by the subcommittee and enforcement authorities in this country.

Great Britain has, in fact, established official channels for exchanging information with the United States in areas other than insurance. Key among these is the DTI's memorandum of understanding with the Securities and Exchange Commission to assist each other on regulatory and enforcement matters affecting publicly-traded securities. The necessary link for such cooperation is statutory action by the United States to empower a Federal agency to reach a formal exchange agreement with British enforcement authorities. There is a clear need to establish a legal basis for cooperation on insurance regulation between two of the world's major insurance markets.

Inability to work with Great Britain illustrates why this country needs to develop its own proper safeguards to control foreign-based operations. British authorities are not responsible for protecting the American market, nor have they shown an inclination to shoulder that task. The United States must accept responsibility for protecting its domestic insurance market.

PART IV

THE NAIC AND STATE SOLVENCY REGULATION

Unlike all other sectors of the financial services industry, insurance is regulated solely by the States. The inherent authority of the Federal Government to regulate insurance matters affecting interstate commerce was relegated by Congress to the States in 1945 through the McCarran-Ferguson Act. Consequently, most insurers must be licensed and regulated by every State in which they do business, although primary oversight and examination responsibilities rest with the insurance commission in a company's state of legal domicile.

This system of multi-state supervision has resulted in regulatory gaps and redundancies that have harmed both insurance companies and their customers. Costly overlaps have not prevented the growing number of large insurer insolvencies, and in many cases appear to have actually contributed to them. The inevitable byproduct of shared jurisdiction has been confusion and passing the buck when tough decisions are needed, fostered by poor communication, tunnel vision, and home State protectionism. In effect, having too many regulators with part-time responsibility means that nobody is responsible full-time for assuring overall solvency or taking charge when disaster strikes.

There is, however, a national presence in insurance regulation. The National Association of Insurance Commissioners (NAIC), a voluntary association of State regulators, helps to coordinate regulatory activities and assist State officials in performing their tasks. As a purely private organization with no governmental authority, the NAIC depends upon the willing cooperation of State insurance commissions in achieving its goals. This has often proved to be difficult, and sometimes impossible.

The subcommittee has always drawn a clear distinction between the NAIC and the State insurance commissions which comprise its membership. Insurance commissioners and their staffs are government employees who exercise a State's legal powers to regulate commerce within its jurisdiction. Even under the best circumstances, the NAIC can never match the capabilities of State and Federal regulators to take binding actions that are enforceable in court through civil or criminal penalties.

State regulatory officials are unable to correct single-handedly the national and international solvency problems observed by the subcommittee, because they lack authority to supervise an insurance company's business beyond their own borders. Nonetheless, State commissions can be quite effective in dealing with local concerns when they are sufficiently motivated and armed with the necessary resources. This has been amply demonstrated in recent

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years in States where large-scale insolvencies have produced a public backlash.

California has the Nation's biggest insurance market, as well as a lion's share of the documented cases involving management knavery and incompetence at insurance companies. Tellingly, Los Angeles served as home base for three of the monstrous insolvencies studied by the subcommittee—Mission Insurance Co., Transit Casualty Co., and Executive Life Insurance Co. Major earthquakes, riots, fires, and automobile losses have also taught Californians about the perils of uncollectible offshore reinsurance and unpaid claims by weak insurers. In response, the State legislature and a vigorous elected insurance commissioner are revamping the once cozy regulatory atmosphere which permitted such abuses.

Texas and Florida are two other large States where public anger over insurance mismanagement and arrogance have fueled more active regulation. Both have experienced a spate of headline-grabbing frauds and insurers that vanish on the heels of claims-producing adversity. Somnolent regulatory officials were replaced en masse by a new Governor in Texas, while Hurricane Andrew and life insurance scandals have energized the climate in Florida. Statewide political races in California, Texas, and Florida now feature insurance reforms as a key issue for voters.

Having been at the forefront of insolvencies and unpaid claims, insurance commissioners in all three of these States have been the most vocal about using Federal authority to curb national and international abuses beyond their effective reach. In particular, they have called for Federal regulation of alien companies which enter their States unchecked. Consumers in California, Texas, and Florida have tired of being the unknowing benefactors who pay the costs of regulatory indulgence and indifference in offshore locales.

Several smaller States have also focused renewed attention on insurance abuses. One common factor among all the States exhibiting more diligence is their shared experience as sites of the worst savings and loan offenses. They apparently have learned that milking the public's trust in traditionally sacred financial institutions is a popular method for bilking the public's money.

Regrettably, corruption by some insurance commissioners while in office is another force behind calls for reforms at the State level. During the past 5 years, Federal prosecutors have obtained criminal convictions and jail sentences for two successive commissioners in Louisiana and a third in Wyoming. The insurance commissioner in Mississippi is reportedly the subject of ongoing Federal investigations regarding his conduct in office. The susceptibility of some State commissioners to bribery and influence peddling cannot be ignored, and must be considered when crafting a credible national solvency regulation program.

THE MORE THINGS CHANGE . . .

The subcommittee has encapsulated its findings about the present State regulatory system under the rubric *Wishful Thinking*. The powerful urge to believe what one wishes to be true in the regulatory world usually manifests itself as a preoccupation with continuously perfecting the system of solvency standards and procedures. Establishing new programs and computer systems are

other areas which create the opportunity for regulatory officials to keep busy working on projects where success is self-defined. While these efforts may seem divorced from the actual supervision of insurance companies, they are capable of being administered and evaluated internally by regulators according to the procedures in their manuals. The purposes and results of such programs are important to the officials who believe in them because they can experience progress in handling solvency issues.

The subcommittee's conclusions about regulatory avoidance are not new. A former New York insurance superintendent and president of the NAIC, Richard E. Stewart, made the same observations 25 years ago. Arguing against the "rituals of regulation" that were sapping the purpose and vitality of State supervision, he said:

> For a long time, the regulation of insurance, like the regulation of other kinds of business, has been concerned with parts and not entireties; with rules, procedures and mechanics, not with objectives and results. We have so spun our laws and precedents as to have determined to the uttermost nicety how we want the minutest part of the insurance business to behave . . . While baffling the average man with our mastery of what he cannot understand, we have often left him with the impression that we do not care enough about what he does understand—and what he understands is results.

THE NAIC'S RESPONSE TO SOLVENCY CONCERNS

Four years ago, the NAIC resolved that it should be at the forefront in aggressively constructing and promoting a national solvency program. To accomplish this goal, the organization adopted a two-pronged approach toward improving individual State solvency regulation to a level deemed acceptable by agreement of its membership. The NAIC first decided to intensify its traditional role as developer of model laws that State legislatures should enact to assure sound regulatory authority.

Although developing model laws does not address the problems of implementing them, this approach has the advantage of pursuing solvency matters through channels which are familiar and acceptable to regulatory officials and the insurance industry. To deal with implementation, the NAIC went a step beyond its normal practice by bundling its solvency-related standards into a single package that it decreed must be enacted as an entirety. Going still further, the NAIC has also attempted to enforce its solvency package by means of a freshly-created certification process.

The second prong of the plan adopted by the NAIC was to increase the level of its direct administrative support to State regulators. While limited efforts in this direction already existed for securities valuation and admitting alien insurers, their importance was elevated by associating them with the new packaging concept developed for meeting solvency concerns. In addition, substantial financial analysis and enforcement information functions were undertaken by the NAIC, changing its role even more from advisor to regulatory participant.

The NAIC then moved to an active stance for pressuring State government officials to enact its entire solvency program. The group's leadership publicly announced in 1991 that a substantial majority of States would adopt the program and be independently accredited by January 1, 1994. Insurance companies domiciled in States failing to meet the NAIC's deadline would not thereafter be accepted automatically by fully-accredited State commissions.

The move to pressure tactics was a major departure from the group's past behavior of using gentle persuasion to encourage adoption of its model laws. It was also a bold challenge for individual State commissions to comply with the NAIC's edicts, or face ejection from the community of members in good standing. This extraordinary demand was coupled with the NAIC's widely proclaimed 3-year adoption timetable, yet many substantive provisions in the mandatory standards package were incomplete when the announcement was made.

Not surprisingly, the adoption process has been plagued with formidable obstacles and controversies. There have been complaints that the NAIC originally presented State legislatures with an ultimatum to enact an incomplete and hastily-conceived program whose content could not be properly evaluated. While NAIC leaders have since praised continual changes in their program as "evolutionary", many State legislators apparently view them as an endless string of new demands that require too much legislative attention.

State antagonism at the pace of new model standards has been echoed by resentment over their source. Despite its self-professed wholesome intentions, the fact remains that the NAIC has not been appointed to conduct its solvency mission by any State or Federal Government, nor is the group directly supervised by any government. Elected government legislators and executive officers generally do not appreciate having a pre-established legislative program and completion schedule handed to them by a private organization for ratification.

Practical limitations have also arisen. The staffing and training requirements promulgated by the NAIC seem to have outstripped the capabilities of several State insurance commissions, including some which have been certified for accreditation. Deficiencies are concentrated in performing examinations of licensed insurance companies, one of the most important functions assigned to regulators. This has led to bending the rules in order for the NAIC to conclude that States are complying with its solvency program.

A PUBLIC PERSPECTIVE ON THE NAIC

When the subcommittee began its insurance solvency inquiry in May 1988, the NAIC had just established its Committee on Financial Regulation Standards to develop a set of comprehensive baseline standards for State regulators. The NAIC voted in June 1990 to accept the standards recommended by the committee, and to initiate an accreditation program for certifying those States which adopted all of them. This started the NAIC's proliferation of new and amended model laws regarding solvency, as well as the rapid growth of expanded support services by the organization to assist State insurance commissions.

The subcommittee has monitored the NAIC's solvency program since its inception through annual public hearings featuring testimony by the U.S. General Accounting Office (GAO) and the NAIC's leadership. Dual presentations have proven to be an excellent means for gaining a balanced perspective on the program's scope, mechanics, and promised results from its enthusiastic sponsors, as well as objective audit professionals. To date, subcommittee hearings regarding the NAIC's program have been held on May 22, 1991, April 9, 1992, and June 9, 1993.

At the subcommittee's request, the GAO spends several months each year evaluating the standards and accreditation documents furnished by the NAIC and State regulators. In addition, GAO auditors attend the group's meetings, conduct interviews with appropriate NAIC and State regulatory staff, and have accompanied accreditation teams assigned by the NAIC to review the insurance commissions in Illinois and Oklahoma. All of the GAO's work is performed in accordance with Generally Accepted Government Auditing Standards, and GAO auditors discuss their findings with senior NAIC officials prior to each of the subcommittee's hearings.

These GAO audits and subsequent public hearings constitute the first and only independent oversight given to the NAIC's solvency program and organizational structure. Accordingly, both the subcommittee and the GAO have been careful to treat the NAIC with fairness and respect, while still observing all procedures needed to obtain meaningful public review of this heretofore closed organization. The NAIC has generally cooperated on most document and interview requests, although its officers have occasionally voiced complaints alleging negative bias and unfair treatment by the GAO. Such reactions are often heard by the subcommittee from persons unused to public scrutiny, but they did not detract from the overall cordial atmosphere which helped make the subcommittee's hearings exceptionally productive.

The three annual hearings held by the subcommittee provide a valuable log of the NAIC's plans and accomplishments at regular intervals as its solvency program has evolved. At the first hearing in May 1991, the program was in its infancy, with only two States accredited. A total of nine States were accredited by the time of the next hearing in April 1992, and 18 had been formally recognized by the NAIC when the third hearing occurred in June 1993. At its self-imposed completion deadline on December 31, 1993, the NAIC had officially certified 32 States, and the list had reached 36 by June 1994. This number does not include New York, one of the first States approved in 1990, which had its accreditation suspended in March 1993 because the State legislature failed to enact two model laws required by the NAIC.

THE NAIC'S SOLVENCY PROGRAM: AN OVERVIEW

The NAIC believes its solvency program, named the Financial Regulation Standards and Accreditation Program, is a solid testament to the willingness of State insurance regulators to work together, and that it far surpasses the efforts of Federal regulatory agencies. The group's president gave the program a ringing endorsement in his 1993 testimony to the subcommittee:

> No Federal regulatory agency has undertaken enhancements in capacity and quality of regulation that could compare with those undertaken by the NAIC and State insurance departments in the last 3 years. State regulation works well and the accreditation program has proven its mettle from its inception.

Briefly, the NAIC's program is built upon three categories of standards. The 27 Part A standards are designed to determine whether a State has the authority needed to regulate an insurance company's affairs. Among other things, the State commission must be empowered to examine companies, require a minimum amount of capital, prescribe uniform accounting practices, and take corrective actions against insurers. Seven of the Part A standards were not adopted until March 1993, and they will apply only to accreditations made after January 1996.

In the second category, there are 12 Part B standards intended to assure that a State has the appropriate resources to conduct financial analyses and on-site examinations of insurers. The third category includes six Part C standards governing organizational and personnel practices of insurance commissions. These cover such issues as educational and professional development requirements for department staff.

Compliance with solvency standards promulgated by the NAIC is determined through a newly-instituted accreditation process. The NAIC appoints a review team to visit each State insurance commission applying for accreditation. Usually, the review team consists of five people who conduct an on-site evaluation for 3 to 5 days. They look over the State's insurance laws, talk to department staff, review examination reports and procedures, and observe the commission handling its daily regulatory responsibilities.

The appointed review team grades a State commission by how well it satisfies every one of the standards required under Part A, Part B, and Part C of the NAIC's regimen. According to the NAIC, a State must "substantially comply" with all Part A standards. Additionally, the State is rated on its compliance with Part B and Part C standards based upon a four-point scale, consisting of "excellent", "good", "acceptable", and "unacceptable". A minimum score of "acceptable" is mandatory on each standard, and the scores must average "good" for all Part B standards taken together and all Part C standards taken together.

If the NAIC review team believes a State meets the accreditation requirements, it makes a favorable report to the organization's Financial Regulation Standards and Accreditation Committee. That committee then votes on whether to accredit the State. The recommendation of the review team is generally accepted.

YOU CAN'T GET THERE FROM HERE

When the GAO testified before the subcommittee in 1991, the agency was asked to assess the capabilities of the State system to establish and maintain effective national solvency regulation. The subcommittee had issued its *Failed Promises* report 1 year earlier questioning the efficacy of State authority and resolve to deal with solvency matters. That report described a disturbing growth in the

size and complexity of insurance company insolvencies that bore a striking resemblance to the pattern of events which caused the collapse of the savings and loan industry. Four insurer failures investigated by the subcommittee showed a web of management fraud and abuse projected to cost the public $5 billion, yet none of them were detected or stopped by State regulators.

The GAO's first report on the NAIC's efforts to construct a national solvency program was somewhat limited because the program was just starting. However, the GAO's response to the general question of State regulatory capabilities was both prophetic and troublesome in its implications. The GAO made three major findings:

(1) The State-by-State system of solvency regulation suffers from inherent weaknesses because the large variances in quality, commitment, and resources among State insurance commissions are unlikely to be overcome;

(2) An effective national regulatory program mandates the use of compulsory interstate authority which the NAIC and State insurance commissions do not possess; and

(3) The NAIC cannot be granted Federal legal authority to implement its program because that would create intolerable responsibility conflicts for the State officials who constitute its membership.

While acknowledging the NAIC's laudable efforts to improve State solvency regulation, the GAO told the subcommittee that the group's lack of compulsory authority severely hampered its ability to sustain such efforts over the long term. The GAO concluded its remarks by saying, "The main road to effective regulation of the insurance industry does not pass through NAIC."

The fundamental problems which prevent the NAIC from instituting an effective national solvency program derive from innate differences among the States. Quite clearly, insurance commissions reflect the agendas of the State governments which produce and fund them. Each of the 50 States has its own political system that determines what issues will be addressed, and those issues constantly change in response to the choices made by a State's voters. The NAIC cannot control the ongoing agendas of State governments, so the success of its program necessarily depends upon good-faith projections of voluntary cooperation and support.

THE PROOF IN THE PUDDING

In addition to inherent legal deficiencies, the practical difficulties in applying the NAIC's standards were described by the GAO during its yearly testimony to the subcommittee. The GAO faithfully reported actual results as the NAIC developed and implemented its solvency program over a 3-year period. Real experience in making the program work as promised uncovered many of the substantive and procedural flaws that NAIC critics had predicted would inevitably occur. However, those setbacks also illustrated a high degree of ingenuity and practical rationalization by NAIC officials determined to see their creation succeed.

It is important to note that the GAO never criticized the subjects chosen for the standards included in the NAIC's program, although their merits were fiercely debated within the regulatory community

and the insurance industry. Instead, the GAO focused its observations on weaknesses that would hinder the effective implementation of any rule by any organization facing similar obstacles. Thus, the value of the GAO's input was independently evaluating the program's productivity and efficiency in light of its stated goals.

There are three basic areas where the GAO found lasting faults in the NAIC's solvency program. First, the standards are too vague and permissive. Second, implementation of the standards is given insufficient attention, and third, the decisions of the accreditation review teams are not always properly supported. A look at these areas illustrates why the NAIC has not convinced the public and much of the insurance industry that the program solves well-recognized problems, even in those areas where State regulators have jurisdiction to act.

VAGUE AND PERMISSIVE STANDARDS

The NAIC operates primarily by seeking consensus agreement among its member insurance commissions. If such agreement is unattainable on a particular proposed standard, the substance is usually lowered or altered enough to reach general acceptance for adoption of the standard. This is a normal drawback of decision-making by voluntary membership organizations, where imposing unpopular rules is not feasible. At the NAIC, the situation is further complicated by a desire to obtain concurrence from powerful industry groups.

In its 1991 testimony, the GAO reported that certain NAIC solvency standards are too vague to provide meaningful guidelines for regulators. These standards set no exact criteria for taking needed actions, so there is no assurance that States adopting them will reach similar decisions. Without such assurance, the NAIC's program creates only an appearance of uniform regulation. As examples, the GAO cited standards requiring accredited States to make insurance companies maintain "minimum" capital and surplus amounts and a "diversified" investment portfolio, without specifying what such general terms mean.

Another example concerned the standard dealing with financially troubled insurers. The standard does not establish a uniform measure to ascertain if a company is "financially troubled", nor does it mandate what regulatory actions should be taken in such situations. Imprecision typically leads to regulatory indecision and delay, which the subcommittee has found to be extremely costly to the public in the cases it has studied.

By the time the GAO testified in 1992, the NAIC had accredited enough State commissions to provide a body of evidence from which to judge how its standards were being applied in practice. The GAO discovered that nebulous standards were indeed permitting accreditation review teams to reach very permissive interpretations. Because the problem was sufficiently widespread, the GAO concluded that the accreditation program does not really establish a meaningful minimum level of solvency regulation, despite the NAIC's claims to the contrary.

For example, North Carolina was accredited even though the insurance commissioner has discretionary authority to waive all provisions of the holding company regulation law required by the

NAIC. Kansas was missing one important section of a mandatory law, but was certified anyway. The NAIC said Kansas should correct the deficiency within 2 years.

The solvency program directs each accredited State to have sufficient resources to examine the financial condition of all licensed insurers on a periodic basis. Though no specific frequency is stated, most States examine a company once every 3 to 5 years. This extended period was woefully infrequent for the failed insurers investigated by the subcommittee. Nonetheless, the NAIC stretched the examination standard's interpretation even further to accredit Wisconsin, which had not examined some of its largest insurers in 8 to 10 years.

Another standard requires an insurance commission to have certain types of professionals available on its staff or on contract, such as computer specialists, actuaries, and reinsurance experts. The NAIC's review team found that the Ohio commission did not have access to any of these required professionals, yet rated the department better than "acceptable" on this standard. Ohio was subsequently accredited. When asked at the subcommittee's 1992 hearing if this is a strong regulatory structure, the NAIC's president replied, "Yes, it is."

Under the solvency program, financial examiners in accredited States must adhere to provisions of the NAIC Examiner's Handbook. Considerable differences among the workpapers of examiners in Iowa indicated that the Handbook was not being followed. There was little evidence of compliance with the requirements for planning, review of CPA workpapers, or assessment of risk on some accounts, pointing to inadequate staff supervision. Iowa was rated better than "acceptable", and went on to be accredited.

Eighteen State insurance commissions had been accredited when the GAO and the NAIC testified in 1993. The NAIC contended that "States seeking certification are placed under a microscope to determine compliance with the standards", yet the GAO again concluded that loose interpretations of vague standards were undermining the program. All accredited States had variations to the NAIC's model laws, and some of those differences seemed to nullify the intent of the laws. The NAIC maintains that statutory language for each standard adopted by accredited States must be "substantially similar" to the provisions of the model law, but "substantially similar" is yet another important term that the NAIC has not defined. Consequently, the accreditation review teams have no guidance on how to judge the laws and regulations existing in a State.

The GAO emphasized that precise definitions and guidelines are essential when the same standards are applied at different times by different people. In addition, the rules need to be implemented uniformly in order to achieve standardized results. Because the NAIC has failed to follow these procedures, its solvency accreditation program cannot produce uniform minimum regulation on matters where State commissions have authority to act.

The NAIC did try to make one key provision of its program more specific, but was unsuccessful. The group attempted to tighten the section of the model holding company act which sets the threshold for getting prior regulatory approval before a dividend can be paid

from an insurer to its holding company. This provision is intended to prevent the type of holding company raids that bankrupted the Baldwin-United Insurance Co.

In October 1991, the NAIC decreed that the extraordinary dividends section of the Model Insurance Holding Company Act must be enacted verbatim by accredited States. By then, several States with lesser dividend thresholds had already been accredited, and the NAIC met with strong protests from industry, regulators, and State legislators. The NAIC reversed its ruling, and justified the reversal by saying it would not diminish a State's ability to control dividend payments. This step backward was hailed by NAIC leaders as evidence that they wanted to avoid excessive rigidity, but outside observers said the NAIC bowed to pressure for a weaker standard.

LITTLE FOCUS ON IMPLEMENTATION

Laws, regulations, and procedures granting adequate authority must be in place to enable a regulator to be effective. However, the existence of the appropriate regulatory structure alone does not assure high quality regulation. The manner in which a regulator exercises those laws, regulations, and procedures is equally important.

There is too little emphasis on how well solvency standards are actually implemented in the NAIC's accreditation program. In its 1992 testimony, the GAO reported that the NAIC sometimes accredits States merely because the *potential* exists for effective regulation. For six of the seven States certified the prior year, the NAIC's review teams found insurance commissions in compliance based on some standards which had just been enacted, and thus had no track record of being applied.

A good example of certifying on the basis of pure speculation is South Carolina's accreditation. The review team concluded that new authority given to the insurance commission complied with NAIC standards largely on the basis of how the commission's staff planned to implement it, as well as how they might have used it in the past. Another example is North Carolina, where the NAIC review team found the commission in compliance with the standard for sufficient examination resources, even though there was an examination backlog. They did so, in part, because the commission had posted job announcements for examiner positions.

By the time the GAO testified in 1993, the NAIC had acknowledged that the accreditation process must look more closely at the manner in which State insurance commissions are implementing its solvency standards. However, the GAO said the NAIC planned no immediate changes because it did not want to subject unaccredited States to a different approval standard. Apparently, the NAIC intends to wait until its second round of 5-year renewal accreditations begins in 1996 before making improvements in measuring whether standards are being enforced.

The GAO reiterated the importance of good standards implementation by documenting the deleterious effects of poor performance on the quality of financial examinations. The GAO told the subcommittee that inadequate focus on regulatory competence was permitting States with significant examination weaknesses to be

accredited. This is especially troubling because examinations, which are infrequent at best, are the principal means available to regulators for verifying insurer-reported data and detecting financial difficulties.

According to the GAO, the NAIC's review teams were consistently finding that State commissions failed to comply with fundamental examination standards, but were certifying them anyway. Seven of the ten States which had been accredited during the previous year were cited for not following the NAIC Examiner's Handbook. The review teams approving them also found deficient testing of loss reserves, incomplete internal control assessments, and improper reliance on unverified information provided by insurance companies and their audit firms.

UNSUPPORTED DECISIONS

At its first appearance in 1991, the GAO warned that a lack of documentation and established review procedures in the accreditation process made it impossible for an independent observer to judge whether certification decisions were supported by factual evidence. Hence, there was no dependable way to evaluate the work of the NAIC's review teams, or to ensure that solvency standards were being applied equally to each of the State commissions seeking accreditation. The NAIC had improved documentation by 1992, but it still remained insufficient to explain the basis for decisions made by review teams. More improvements did not cure the deficiencies, and the GAO reported again in 1993 that documentation problems persisted.

Absent uniform documentation and review procedures, interpretations of solvency standards are made on the spot by NAIC review teams on each engagement, and they vary according to the mood, expertise, and composition of a team. Some of those ad hoc decisions can be very curious indeed. For example, the failure of Ohio to retain the computer, actuarial, and reinsurance specialists required by the NAIC was absolved through the following twist of logic: The review team determined that Ohio's examination staff would have requested the required professional expertise if it was needed. Since the Ohio examiners did not request such expert assistance, it was considered not to have been needed.

During the 3-to-5 year period between full examinations, insurance commissions are supposed to monitor solvency by analyzing the financial statements submitted to them by licensed companies. The quality of this analysis determines to a large extent whether a commission will be able to detect financial problems before they escalate beyond control. Although the analysis function is a critical regulatory tool, the GAO could not determine what constitutes an acceptable level of performance because the NAIC has not developed the necessary criteria. Therefore, the decision by a review team to approve a State's financial analysis capability is primarily a subjective judgment.

The NAIC's scoring system can also mask the true condition of a State's examination capabilities. When tallying the final score from the ratings given on compliance with individual standards, review teams can offset weaknesses in one area with strengths in another. The GAO reported that the NAIC accredited Wisconsin, de-

spite its examination weaknesses, because the State's insurance commission had a particularly good financial analysis system.

GROWING RESISTANCE TO NAIC REFORMS

According to the NAIC, one of the virtues of the solvency program is its dynamism. New standards can be added and old ones amended to respond to changing industry conditions. However, the problem with this arrangement is that the NAIC must go through 50 State legislatures whenever it wants to make a change in its standards have nationwide effect. That process is lengthy and fraught with uncertainty.

In its 1993 testimony before the subcommittee, the GAO warned that growing resistance to the solvency standards proposed by the NAIC was threatening the long-term viability of the program. The GAO said opposition was coming from State legislators, regulators, and industry representatives. The surge of enthusiasm accompanying widespread passage of the NAIC's initial standards package had waned, and was being replaced by a dour mood among legislators that enough time and attention had been devoted to the solvency issue.

Testimony by the NAIC's senior officers strongly disputed the GAO's assessment that serious resistance to the solvency program was increasing. They stated:

> One of the strengths of the Financial Regulation Standards is that they are designed to evolve as our understanding of effective solvency regulation evolves. Each year, the bar over which States must jump in order to qualify for NAIC certification is raised, as we add new standards and improve and clarify existing ones.

Under questioning by the subcommittee, the NAIC's president said he had seen no evidence of resistance or program erosion. Regarding the GAO's opposite conclusion, he added: "[F]rankly, I do not know what that is based on other than perhaps perceptions or impressions or hearsay from those in the industry."

Only 5 months later in an address to an industry trade group, the same NAIC president contradicted the message he had given the subcommittee. He said it was time to give "weary" lawmakers a break from the onslaught of new solvency legislation, and that even he was getting a little tired of constantly hearing about additional model laws at NAIC meetings. He went on to say: "We need to become more sensitive to the extent to which we are seeing more and more State legislatures resisting the adoption of some laws," and also, "As the old saying goes, you can't go back to the well every year, because after a while lawmakers are going to start questioning just why we keep coming back with new proposals to clean up the same insurance problem—solvency."

At the National Conference of Insurance Legislators annual meeting 2 weeks later, the chairman of the NAIC's Financial Standards and Accreditation Committee repeated the call for a retreat from earlier pledges that the NAIC would continue pushing for better standards. He said the NAIC had "screwed up" by frequently changing its accreditation standards, that "it was a mistake" for production of model laws not to have been curtailed "a

couple of years ago", and that it was time to allow State regulators and legislators an opportunity to "catch our breath." This official suggested that a moratorium on additional standards should be considered.

The current situation remains clouded by conflicting signals from the NAIC regarding the likelihood of more improved standards. The uncertainty is illustrated by the inaugural remarks of the newly-elected NAIC president in 1994:

> There will be no moratorium; no time out in the development of the standards necessary to protect consumers. Having said that, we are sensitive to the priorities and prerogatives of legislators. We will continue to work with them to assure that standards are not added in a haphazard fashion.

Clearly, changing attitudes and conflicting statements by the NAIC's leadership show evidence of diminished enthusiasm for pushing States to constantly improve solvency regulation through adding new standards each year. The future direction of the organization on this issue is presently unclear.

BACKPEDALING ON SANCTIONS

The NAIC engaged in some tough talk when its leaders first testified before the subcommittee in 1991. Having boasted that the new solvency package and accreditation program were being adopted in record time by eager State legislatures and regulators, the group's leadership warned of serious repercussions for States which failed to get accredited. The NAIC's firm resolve to pursue stern enforcement of its standards was emphasized in testimony by the group's past president:

> We do not view these standards as voluntary, and the impetus for States to comply with the NAIC standards does not rest merely on the policy notion that every State ought to comply with [the] standards. Rather, the State insurance departments have devised sanctions, which are based on their legal power to impose regulations on insurers doing business in their respective States. Accredited States will impose additional regulatory requirements on companies based in non-complying States. For example, beginning in January 1994, accredited States will not accept reports of financial examination from non-accredited States.
>
> Additional restrictions on companies based in non-accredited States are being developed. The NAIC is considering a model act which would sanction companies domiciled in non-accredited States by requiring them to meet the solvency regulations of every accredited State in which they do business. As a result of these and other contemplated sanctions, being domiciled in a non-accredited State will increasingly become a liability, inducing States to either meet the standards or witness the re-domestication of their companies.

The NAIC's ability to penalize State governments which do not meet its standards has generated skepticism among many observ-

ers. Coercing its membership and their sponsoring governments runs counter to the NAIC's long-standing traditions. Furthermore, the threat of making accredited States conduct extra financial examinations on companies from unaccredited States rings hollow, since most State commissions have great difficulty handling their present examination loads. In an ironic twist, the NAIC has decided to enforce its program by ordering redundant financial examinations on a State system which is already saddled with regulatory redundancy.

Confronting the State government system has cost the NAIC dearly. The organization was forced to suspend the accreditation of the New York Insurance Department, one of its premier members, because the State legislature failed to enact two model laws on the schedule dictated by the NAIC. In its 1993 testimony to the subcommittee, the NAIC cited this painful move as proof that it was serious about enforcing the rules of the solvency program:

> Also in the past year, the NAIC has suspended the certification of one State, New York. This action was taken last March, when it became clear that the State of New York had not enacted two model laws and parts of a third model law that, as of December 1992, were required for certification. After an opportunity for a hearing, the Financial Regulation Standards and Accreditation Committee suspended New York's certification, pending the enactment of the requisite laws.
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> It is important to note that the State of New York has an excellent department and does a superb job of protecting that State's insurance consumers. However, it is a testament to the Financial Regulation Standards and Accreditation Program that a department of such high caliber can be denied accreditation status if it does not possess the statutory tools deemed necessary for effective solvency regulation.

The NAIC's effusive praise of an insurance commission that does not meet its standards raises important questions about the usefulness of the highly touted solvency program. How can the New York Insurance Department be "excellent" if it fails to satisfy NAIC standards? Conversely, what good are the standards if the New York Department is "superb" without them?

Although citing it as a sign of strength, the suspension of New York highlights the NAIC's fundamental weakness—its inability to compel State governments to follow the group's directives. The action also illustrates the absurdity of trying to isolate one of the largest and most influential States from the community of accredited insurance commissions. It simply is not practicable for other State commissions to re-examine the hundreds of insurance companies domiciled in New York, yet that is the sanction demanded by the NAIC's rules.

The New York legislature has not idly accepted the NAIC's rebuke. The chairman of the State's Senate Insurance Committee called the suspension "political blackmail" that holds a duly elected government "hostage to the whims of a private trade association." This State senator has refused to move the bills promoted by the

NAIC, and has also asked New York's Governor to halt State contributions to the organization. The Superintendent of Insurance in New York said he hopes other States will continue to accept insurers based in his State, because the NAIC "is an advisory body and accreditation is an advisory program."

As a result of the dispute over NAIC's certification, New York enacted legislation to respond to the possible retaliation against insurers domiciled in the State. This legislation, similar to that which had previously been enacted by Texas, provides that if any New York domestic insurer suffers any sanction, fine, or other penalty issued by the insurance department of any other State due to the NAIC accreditation requirements, the New York Superintendent of Insurance shall impose a similar sanction or fine upon the domestic insurers of the NAIC-accredited State.

Perhaps sensing more harsh reactions on the horizon, the NAIC recently softened its tough stance regarding unaccredited States. As the group's January 1994 compliance deadline approached, the rhetoric of isolation and retaliation was replaced with projections of calm transition. The chairman of the NAIC's Financial Regulation Standards and Accreditation Committee predicted in November 1993 that "no significant dislocations" would occur when the sanctions went into effect. The group's president reiterated this message in December 1993 by suggesting that the word "effect" might be more accurate than the word "sanction" to describe what will happen to unaccredited States after the deadline.

Three significant events helped to avoid severe disruptions which might have created a regulatory breakdown in dealing with unaccredited State insurance commissions. The first was a phenomenal increase in the number of States certified by the NAIC. The total grew from 18 at the time of the subcommittee's last hearing in June 1993 to 32 before the sanctions took effect on January 1, 1994. As documented by the GAO, the NAIC's lack of procedures, poor documentation, and loose interpretations render accreditation decisions unfathomable, so there is no reliable method for the public to evaluate the rapid stream of approvals which culminated 1993.

Second, there was a flurry of last minute examinations conducted by unaccredited insurance commissions to beat the December 31, 1993 deadline. The NAIC's accreditation committee chairman concluded that this tactic would result in no major sanctions being applied during the first 6 months of 1994.

The third event was a major change by the NAIC in defining what it would consider to be an acceptable examination report. The organization decided to let unaccredited State commissions "borrow" a qualified examiner from an accredited State. The borrowed examiner would supervise or participate in the financial examination of an insurance company, and then certify in writing that it was completed according to the NAIC's solvency standards. "If that's done, even the report from a non-accredited State would be recognized by the accredited States," the group's accreditation chairman told a State lawmaker's association.

The move to permit borrowed examiners alleviates the logistical logjam facing State regulators under the NAIC's examination sanctions, but it also undermines the incentive to adopt the solvency

program in the first place. One State legislator, hearing the NAIC's explanation of the borrowing concept, pointed out its effect to the chairman of the accreditation committee: "Aren't you then just saying that there is a way to get around this? None of the States really have to do all of the enactments that you are requesting. They just get an examiner from an accredited State to do that examination, and the rest is really unnecessary."

Despite the controversies and uncertainties, the NAIC's rule to refuse examination reports from unaccredited States remains in place. The actual results of sanctions which may be applied, if any, have not yet appeared. There seems to be no rush by the NAIC to test the effectiveness of its retaliatory enforcement plan.

THE NAIC'S DIRECT SUPPORT FUNCTIONS

Standard-setting and accreditation are meant to encourage State insurance regulators to do a better job. The hope is that outside pressure and leadership from the NAIC will convince individual States to increase their vigilance, skills, and resources to meet local and national needs. In addition, the NAIC has chosen to improve State regulation more directly by providing support services to State insurance commissions.

The expanding scope of services provided by the NAIC caused the organization to triple its size during the past decade. From its base in Kansas City, Missouri, the NAIC administered a $25.5 million budget in 1993, and most of that amount was spent on database and professional staff services used to bolster the resources and capabilities of State commissions. Support from the NAIC is especially important for smaller States, which cannot afford to maintain the full range of staff expertise needed to regulate insurance companies properly.

Some services are particularly suited to central operation and coordination through the NAIC. The group created a national computer database several years ago for collecting and analyzing the regulatory financial reports required to be filed by more than 5,000 insurance companies licensed in the United States. These reports must be filed using the uniform schedules and accounting rules prescribed by the NAIC, and the data can be accessed by State insurance commissions, other State and Federal agencies, commercial ratings organizations, and the public.

The NAIC's database is the core resource for routine solvency surveillance by State regulators, and the organization has done an impressive job of operating and improving the system under authority granted to it by State governments. Unlike solvency regulation, where States jealously guard their independence, central information coordination and collection is a task that benefits State governments without infringing on their jurisdiction.

Financial analysis of large insurers having national business impact is another area where the NAIC is performing an important service for many of its member commissions. The Financial Analysis Division was formed in 1991 to perform intensive quarterly reviews of targeted companies, improve the financial ratios used to identify weak insurers, and assist the NAIC committees appointed to monitor the condition of troubled companies. This division analyzes selected insurers on a nationwide basis, focusing on business

activities which could escape the notice of individual State commissions.

Other NAIC support services include education, training, research, statistical reports, audit assistance, and reinsurance expertise. All of these are within the ambit of services which can be performed competently and efficiently by a well-funded trade association. Such activities augment the abilities of State regulators, but do not relieve them of the responsibility to act when problems are identified.

The NAIC, however, has also become involved in providing services which are beyond its authority and competence. The organization has run into difficulties attempting to rate the quality of investment securities, monitor foreign insurance companies, and serve as a clearinghouse for enforcement information. The considerable sums spent on these activities have not produced the promised results. More importantly, though, these ineffective efforts have misled some people into believing that real regulatory functions are being performed by the NAIC in areas of vital importance, a most dangerous delusion.

SEE NO EVIL: ALIEN WATCHING BY THE NAIIO

The NAIC attempts to register and monitor foreign insurance companies through its Non-Admitted Insurers Information Office, better known as the NAIIO. This operation commenced in 1963 after Congress held hearings which revealed that fraudulent and unlicensed foreign insurers had no trouble gaining entrance into the U.S. market. In 1990, this subcommittee reached the same conclusion based on its own investigations and hearings. Accordingly, the subcommittee decided to ask the NAIC what the NAIIO had been doing for the past 30 years.

At its June 1993 hearing, the subcommittee queried the NAIC's leadership regarding the NAIIO and the organization's other foreign-oriented activities. Understanding such international monitoring and outreach efforts is essential, because the NAIC has proposed Federal legislation that would grant it legal authority to serve as the official "gatekeeper" for the United States. The NAIC wants to control the entry of all alien insurers and reinsurers coming into this market, including the vast majority which the NAIIO presently ignores. Such a step would broadly expand the potential impact of its decisions.

Until October 1993, the NAIIO was managed for several years by John Darwood, a British expatriate who formerly had been the first insurance commissioner of the Cayman Islands. He managed the NAIIO with one full-time assistant, but was able to draw on financial and legal expertise from other NAIC departments. Since Mr. Darwood also seemed to function in many ways as the foreign office of the NAIC, he was invited by the subcommittee to testify with the organization's leadership at the 1993 hearing.

The NAIIO's current mission, apparently, is to screen alien insurers that are not licensed or regulated in the United States, but want to do business here anyway. These insurers freely operate in the "surplus lines" market used to obtain difficult insurance coverage for commercial and governmental clients. In addition, the NAIIO serves as a general clearinghouse for information regarding

foreign companies and regulatory agencies, and coordinates the NAIC's annual International Conference of Insurance Regulatory Officials.

A glance at the methods used by the NAIIO to screen alien companies provides some clues as to why there are still so many cases of offshore fraud and insolvency afflicting the United States. Simply put, the NAIIO does not look for problems. Instead of monitoring the weak companies and bad operators, the NAIIO publishes a quarterly listing of 77 companies that are willing to file reports with the NAIC, and pay a fee for its blessing. Two-thirds of these companies have been on the NAIIO's approved list for more than 10 years, and the NAIC considers them to be among the best foreign participants in the U.S. marketplace.

A preoccupation with ignoring the worst while approving the best has not prevented the NAIIO from listing some weak insurers, as well as a few infamous insolvencies, in its quarterly reports. Standard & Poor's rated 16 of the companies on the current roster as financially vulnerable, and could not rate another nine companies because they do not meet its rating standards. Six former NAIIO-listed insurers are now bankrupt, and two of those were only delisted by NAIIO when they were officially placed into liquidation.

Alien insurers wishing to join the NAIIO's approved list submit copies of their business organization documents, management biographies, and audited financial statements, as well as the NAIIO's standard financial report in English. They must also satisfy the NAIC's minimum requirements of $15 million in capital, a $2.5 million policyholder trust fund, and a $4,000 application fee. Upon review and approval, companies joining the list need only to file their updated financial statements and pay $2,000 annually to stay on the list. Yearly monitoring by the NAIC is less comprehensive than initial screening, because the organization believes it is familiar with the business activities of listed companies.

The value of the NAIC's alien registration process can be gleaned from its procedures. The NAIC basically accepts the information given to it as being accurate. Occasional questions may be asked about asset quality, but the NAIIO does not independently examine foreign insurers or routinely verify the truth of submitted information. Instead, the organization depends on the vigilance of foreign regulators and audit firms to catch business problems and management wrongdoing. The fate of claimants in the United States is thus left to the competence and altruism of governments in other countries, a matter of serious concern in view of foreign regulatory attitudes seen by the subcommittee.

Actual results of the NAIIO's alien insurer listing process seem to mirror the condition of the insurance industry generally. The good companies do well, and the bad companies go broke. Such a convergence with random observation casts doubt on the worth of the NAIC's evaluation system, as does the organization's disclaimer of responsibility for the accuracy of its information or reliance on its findings. Despite this mediocre record, the NAIC's executive vice president told the subcommittee that Mr. Darwood and other staff were "very active" in monitoring companies, and he praised the NAIIO for being "phenomenally successful."

In reality, the NAIIO's activities have been rather insignificant when compared to the problems posed by fraudulent and insolvent offshore insurers. Although other States use the list in some capacity, only 13 States require alien insurers to be on the NAIIO's quarterly list in order to do business within their borders. The NAIIO-listed companies represent less than 10 percent of the 900 foreign-based insurers publicly rated by Standard & Poor's, but nobody knows the full extent of offshore market penetration in the United States because the NAIC does not collect such information. The NAIC has proposed that NAIIO listing of alien insurers be added to the requirements of its accreditation program, but that move will not overcome the deficiencies in either the accreditation program or the NAIIO's procedures.

HEAR NO EVIL: DISBELIEVING THE FACTS

In its 1993 testimony, the NAIC proudly described the depth and effectiveness of its foreign program efforts, going beyond the registration and listing services of the NAIIO. The group's executive vice president explained that Mr. Darwood and his staff are in "constant communication" and "maintain a very close relationship" with law enforcement and regulatory officials around the world. He added that the NAIC's annual gathering of 50 international insurance regulators is very productive, and that the amount of information exchanged among regulatory and law enforcement participants "is really quite phenomenal."

The subcommittee found during extensive questioning of Mr. Darwood and the other NAIC officials that a "very close relationship" with foreign regulators had obviously colored their views of the deficient standards and indulgent attitudes practiced by offshore insurance agencies. In particular, Mr. Darwood was so affected that he tried to defend and rationalize several examples of foreign dereliction presented to him, rather than condemning them. When confronted with too many unpleasant facts contradicting his complacent views, Mr. Darwood told the subcommittee he refused to believe that what he was hearing was accurate. The subcommittee's questions concerning the NAIIO's competence quickly became compounded by questions regarding its allegiance to the interests of consumers in the United States.

Mr. Darwood's extraordinary notions about offshore regulatory practices, especially in some Caribbean island nations, surfaced early in the hearing. As former insurance commissioner in the Cayman Islands, he was asked how companies were regulated there. Mr. Darwood confirmed that no independent examinations were conducted, and that the regulatory agency relied exclusively on the work done by audit firms employed by insurers. This arrangement suited him as being appropriate supervision, especially when combined with his special skills. Mr. Darwood said: "I think, sir, one of the vital elements of my role in the Cayman Islands, and I think my successors', is a certain ability to know the clients who are walking in the door."

The subcommittee's concerns that regulatory loopholes and lax enforcement attract bad operators received indirect support from Mr. Darwood. After explaining how his regulatory regime had caused many Cayman Island companies to leave, being "thrown

out" or exiting of their own accord, he added: "It is not unusual in the offshore world when one environment introduces legislation for people to move to an unregulated environment." He never reconciled this comment with his overall defense of the island regulators who were creating the environments that attracted sham companies.

The subcommittee delved further into Mr. Darwood's experience by reading him an excerpt, entitled "Role of an Insurance Manager," from the Cayman Insurance Managers' Association promotion booklet:

> The Insurance Manager is considered such a vital part of the self-regulation system in operation in the Cayman Islands that every insurance company must appoint a manager. It could be said that the Insurance Manager may have a conflict of interest, in that as well as having a duty to his client he has also a responsibility to Government if he feels concern regarding the probity and soundness of any insurer or reinsurer under his management for whom he is carrying on business. However, the fact that the Insurance Manager is under such an obligation provides for the smooth operation of the Law with minimum interference by the regulatory authorities which is to the overall benefit of the clients.

Subcommittee members recognized the benefits for island-based management companies and absentee owners of this amazing self-regulation scheme, with its inherent conflicts of interest. They wondered how it served to protect the public. Providing no clear answer, Mr. Darwood questioned the authenticity of the booklet. He admitted that "the manager is in one sense an extension of the insurance department," but he concluded: "The government still exercises its proper role and does its job regardless."

The subcommittee next explored the ramifications of exceedingly low supervisory and capital requirements with Mr. Darwood. He was shown a list of 18 countries around the world which had been considered or used as insurance company domiciles by Carlos Miro, a resourceful crook who is famous for exploiting regulatory weaknesses. When asked which countries he thought were the weakest regulators, Mr. Darwood replied that he felt it "a little invidious" to respond, but was able to identify the Netherlands Antilles as the weakest one.

Mr. Darwood was also asked about minimal capital requirements in Caribbean island countries, where as little as $120,000 is enough to start an insurance company. He resisted any negative characterization of such amounts, saying: "No offshore regulator is going to let you run amok and write as much as you want against a minimum capital." Mr. Darwood's trusting presumption about offshore regulatory diligence has been convincingly disproved many times in cases observed by the subcommittee, and the unhappy result has been enormous uncovered losses for claimants in the United States.

Pressed further on the question of whether the laws, resources, and attitudes in the Bahamas make that island's regulators good or bad, Mr. Darwood demonstrated his extreme reluctance to criti-

cize by replying: "I think that is an unfair characterization. I would say that they could all do better." He was asked again to respond to the question, "Is it a good system, is it a bad system?" Mr. Darwood flatly refused, saying: "I don't care to answer this one."

The subcommittee continued by citing the speedy licensing, inadequate capitalization, and financial secrecy found in the Bahamas, Bermuda, Turks and Caicos Islands, and the Isle of Man. Some of the more revealing examples were included in glossy pamphlets distributed by island representatives at insurance trade conventions in the United States. All of this information was obtained directly from island regulatory agencies and management associations, but Mr. Darwood again questioned the accuracy of what he was hearing from the subcommittee.

Excerpts from picture booklets featuring the ease and benefits of island life were read into the hearing record by subcommittee members. These advertisements explicitly describe regulatory environments that are aimed at luring hidden operators and invisible insurers to the pleasures of offshore domiciles. A good example is a brochure prepared by the Association of Insurance Managers in the Turks and Caicos Islands, which reads in part:

> Plan a visit to the Turks and Caicos Islands to meet with the Superintendent of Insurance and with your trusty but so far faceless manager. In normal circumstances all business with the Superintendent, the Manager, the Lawyer and the Accountant can be completed within 2 days with time left over to visit the bank and open your accounts . . . Do not work on too tight a schedule as you may find it essential that you have at least 2 more days in which to sample the unspoiled beaches, virgin reefs and relaxing atmosphere... Upon the approval of the licence the prescribed capital of the company must be placed in the form undertaken within the application. One very attractive feature of the insurance legislation in the Turks and Caicos Islands is that there is no specific requirement that the approved capital be held in the Islands... All transactions and relationships of a corporate nature will be undertaken in strict confidence. The Confidentiality Ordinance is an implicit part of offshore business in the Turks and Caicos Islands. Your manager, lawyer, accountant, banker and Superintendent of Insurance are all bound by this legal instrument.

The subcommittee's numerous illustrations of grossly deficient regulatory standards and practices failed to elicit any consternation or disapproval from Mr. Darwood. Finally, the NAIC's senior officers interjected to say they agreed that the island regulators were bad in comparison with the standards expected in the United States. Nonetheless, the subcommittee was astounded that it took extended questioning under the glare of a public hearing for the NAIC and its officers to admit the obvious failings of foreign regulators.

Lack of concern and expertise by the NAIC and Mr. Darwood were displayed in other important areas, too. They had little knowledge of the Weavers Stamp company failures in London that

are projected to cost the public, mostly in the United States, more than $5 billion. They did not investigate the impact of this stupendous event on American insurers and policyholders, and were ignorant about its harmful effects on two large domestic insurers—The Hartford and Crum & Forster. When asked what he did upon hearing that the Weavers companies were bankrupt, Mr. Darwood said he was "trying hard to recall that particular case." He could not say with certainty what he did, or whether he was even employed by the NAIC at the time, although the dates clearly coincide with his tenure as NAIIO manager.

Despite the group's assertions that he brought well-recognized skills to the NAIC, Mr. Darwood left the organization in October 1993. He eventually rejoined his regulatory colleagues in the Caribbean as the newly-appointed insurance superintendent in the Cayman Islands. His predecessor left office after being charged by the government with fraud and corruption. Perhaps fittingly, Mr. Darwood's appointment completes the circle on his NAIC experiences by returning him to his original position of island regulator.

The NAIC, which employed Mr. Darwood and trusted his judgment for many years, is still running the NAIIO. The organization has asked Congress to expand the NAIIO's impact by enacting a Federal law to appoint it as the gatekeeper for all alien insurers and reinsurers operating in the United States. When asked how the NAIC would exercise such additional powers, the group's executive vice president told the subcommittee: "I would try to do as good a job with the companies that we would list after the legislation as we do with the ones we list now." This remarkably candid admission underscores the vital importance of establishing credible deterrents to deal with the problems posed by unlicensed foreign companies.

SAY NO EVIL: THE SAD SITUATION

In mid-1990, the NAIC embarked on a new computerized program to collect and disseminate information that could be used by State commissions to track fraud and abuse in the insurance industry. That program was named the Special Activities Database, but the NAIC calls it the SAD system. The group's 1991 testimony to the subcommittee described the SAD system as greatly enhancing the ability of State regulators "to share information on individuals or companies possibly involved in illegal or questionable activities and prevent their infiltration into new areas."

There is a real need for creating a national databank that can be used by insurance regulators to exchange and store sensitive information, but the NAIC is plainly the wrong entity to perform this enforcement-related function. An effective regulatory information program must allow its participants to express their true misgivings regarding persons and companies in the marketplace. As a private non-profit association, the NAIC and its employees are subject to laws prohibiting libel and slander. Since the NAIC cannot shield people from liability, participants entering information into the SAD system have no immunity from civil lawsuits alleging defamation, unless they are protected by Federal or State statutes. Consequently, the program and its procedures are carefully designed to avoid listing anything remotely controversial, and there

is a natural incentive to leave unproven suspicions which could lead to personal exposure out of the database.

Due to the restrictions on its input, the SAD system's database contains nothing more than a random mixture of inoffensive references to news articles, government documents, and occasional inquiries by State regulatory officials. It does not even provide routine updates of information made available publicly through the press, civil litigation, and official government reports. The system's innocuous contents may prevent lawsuits, but they also severely limit its use as a tool for tracking wrongdoers or posting alerts for other regulators. The subcommittee tested the effectiveness of the SAD system by issuing a subpoena in May 1993 to obtain the complete files on 16 named persons who were publicly identified as being involved in fraudulent activities or major insolvencies. The purpose of reviewing the system's output on the individuals selected was to measure the information which could be accessed by State regulators if these persons attempted to engage in further insurance business activities. The NAIC insisted on receiving a subpoena to force its release of the files in order to guard the confidentiality of the information stored in the SAD database.

The NAIC asserts that SAD information is updated "on a daily basis," and that the organization works closely with program contacts "to ensure that SAD contains accurate, complete and current data." Despite these claims, the SAD data delivered in response to the subcommittee's subpoena was inaccurate, incomplete, and out-of-date. The computer entries on the SAD printout given to the subcommittee showed no discernible signs of systematic updating or organization to assist users in searching the file listings. There were blatant omissions and misleading entries in every file requested.

The subcommittee questioned NAIC leaders at its June 1993 hearing concerning the conspicuous gaps and misrepresentations in the subpoenaed data. To the extent that named subjects were mentioned, their present location and status were typically reported incorrectly. The NAIC's glib explanations for these deficiencies were quite revealing about the mind-set that produced the SAD system as a solution for sharing regulatory leads on possible culprits.

THE SAD REALITY

The SAD system contained entries for 14 of the 16 persons named on the subcommittee's subpoena. Because the SAD system excludes substantive information on purpose, the NAIC expects interested users to call the contact person identified for each entry listed. A part-time consultant to the NAIC was identified in the SAD printout as the person to contact for more information on 10 of the 14 files provided to the subcommittee. The last information update in the system from this consultant for each of those 10 files was May 31,1990, 3 years prior to the subcommittee's subpoena.

The first and most publicized person on the subcommittee's list was Carlos Miro, whose foreign and domestic insurance exploits had been chronicled in great detail. Mr. Miro's role in the failures of Transit Casualty Co. and Anglo-American Insurance Co. was thoroughly described in *Failed Promises*, published more than 3 years prior to the subpoena. Subsequently, both the subcommittee

and the press periodically reported on his continuing activities in London and Spain. Finally extradited and convicted on Federal fraud charges in 1992, Mr. Miro had been residing in a Louisiana prison for a year when his SAD file was subpoenaed from the NAIC.

The facts on Mr. Miro, as recorded in the SAD system, were substantially different. The system's printout listed just six news articles and four personal contact reports, none of which provided current information. The SAD entries reported that Mr. Miro was living in Spain, that he had been indicted, that he was being sued by Louisiana for his Anglo-American activities, and that the Texas Insurance Commission suspected he was engaged in offshore reinsurance fraud. All of these facts were at least 1 to 3 years out-of-date. The extensive official record on Mr. Miro's activities produced by the subcommittee and in Federal criminal and civil court proceedings was not mentioned at all.

When confronted with the scant, outdated, and incorrect SAD entries on Mr. Miro, the NAIC's executive vice president, who developed the system, refused to call it inadequate for its intended purposes. He blamed the apparent deficiencies on the subcommittee's misunderstanding of SAD terminology, a lack of chronological order to the entries, and an unexplained "computer glitch" in the printout. While acknowledging that the NAIC's update process was "running a little behind," he stressed that the SAD system provides personal contact sources for people who know how to use it, and concluded: "I think it works very, very well."

The subcommittee next inquired about the failure of the SAD system to list the two top officers who presided over the collapse of Transit Casualty, one of the largest and most notorious insolvencies in history. Their roles in destroying the company were documented by the subcommittee and in the trade press. One of them was tried and acquitted in Missouri for knowingly filing false reports with its insurance commission, an event that might be of interest to other regulators. The NAIC's executive vice president said it was obviously "a judgment call" on whether to enter information in the SAD system, and that "we try not to overload it totally." He suggested the Transit Casualty officers might have been listed on an NAIC database of insurance company officers and directors, if it had been operational at the time.

More incomplete and inaccurate entries were contained in the files for James Wining and William Schonacher. Although they were tried, convicted and sentenced on insurance fraud charges in Kansas City, where the NAIC's headquarters is located, the SAD system had not been updated in 2 years to reflect those events. The group's executive vice president was identified in the database as the appropriate contact person, and he admitted: "It hasn't been updated in a while and I totally agree with you, it should be."

Following the hearing, the subcommittee asked the GAO to evaluate the SAD system. The GAO reported that the system has more than 6,200 entries on over 4,600 individuals and companies, but confirmed that the NAIC does not systematically identify, collect, or add information to the database in order to make it complete and current. The GAO also observed that State regulators may be reluctant to use information from the system due to its lack

of legal protections. The NAIC has not conducted any surveys to determine the usefulness of the SAD system to State commissions.

Calling the SAD project a computer databank is really a misnomer. Apart from using computer technology to list items, there is no system for collecting, analyzing, or entering relevant data that would inform users about a particular person, company, or subject. The SAD system is definitely not a stand-alone resource whose database has intrinsic value. While not admitting such deficiencies, the NAIC has shifted to justifying the SAD program by de-emphasizing the importance of its contents.

In presentations to the subcommittee, the NAIC defended the SAD project as an online forum for making personal contacts with knowledgeable people around the country. This claim is somewhat misleading, however, because only a few people at the NAIC are involved in fielding the substantive questions. Just one part-time consultant is designated as the contact person to provide additional information on many of the items listed in the database. If her personal knowledge is the basis for much of the substance in the system, it would be cheaper and easier to distribute cards listing her name and telephone number to State regulators.

Notwithstanding its high-tech trappings, the SAD system seems to have become an expensive link to the personal recollections and perceptions of a handful of trusted people. The project's output, whatever its real worth, would decline immensely if the NAIC lost the services of those few people, all of whom have other jobs to perform. Having no procedures to sustain its bank of knowledge, the SAD system is essentially not a system at all.

The subcommittee targeted its subpoena to elicit data on cases where the SAD system might be expected to yield the best results. Instead, the system produced information that was insufficient either to learn about a topic or lead a user to more reliable and complete sources. If the SAD system does not provide useful information on well-documented cases, there is little likelihood that it will perform better in tracking obscure persons and companies who are adept at covering their trails.

KEEPING HONEST MEN HONEST

Another troubling aspect of the NAIC's endeavors to assume the role of national solvency arbiter and enforcement agency is the underlying regulatory philosophy expressed by its leaders. Each of the group's key officials testifying at the subcommittee's 1993 hearing voiced an opinion that regulators are helpless in stopping determined liars and crooks, and inferred that judging their effectiveness on the basis of regulatory failures is somehow unfair. They prefer to focus on the progress of the NAIC and State commissions in developing and implementing a body of standards which lifts the minimum solvency requirements for insurance companies following their rules.

The subcommittee has overseen the activities of many Federal and State regulatory agencies through the years. Nearly all of them bemoaned the subcommittee's persistent concern with catching wrongdoers, pointing out that a certain number of dolts and pirates will always populate an industry and elude detection. They insisted that any examination of regulatory failures should be bal-

anced with appropriate recognition and appreciation of their enormous successes.

The NAIC's leadership also expressed this familiar lament. When subcommittee members questioned why State regulators did not stop Carlos Miro, the insurance director of Alaska explained that Mr. Miro is a "con man," and that some people will do everything they can to beat the system. This official said he had reviewed Mr. Miro's testimony from the perspective of a regulator and former local prosecutor, and concluded:

> I always operated from the premise that basically what we tried to do is to pass laws to help keep honest people honest. Mr. Miro does not fall into that category. Mr. Miro is an individual, a convict, who has absolutely no respect for State law, for Federal law or for moral law and his testimony proves that.

The theme that State regulation is intended to monitor the behavior of honorable people was repeated by the insurance commissioner of Florida. Defending the State system, he said: "[W]e do have regulations to regulate the insurance industry as it operates hopefully in good faith with the regulator." The Florida commissioner expressed doubts that more regulations would help the system avoid determined wrongdoers, and added: "I mean, we are dealing with crooks."

What purpose does the current State regulatory structure serve if it is not oriented toward finding and stopping the people who violate its rules? Apart from its lack of authority to handle interstate regulation, the fundamental problem with State supervision of insurance companies is the emphasis on instituting new rules, rather than enforcing the ones which already exist. The NAIC's solvency accreditation program, with its torrent of additional standards meant to correct weaknesses, is a classic demonstration of the priority given to rule-making. While the NAIC was expending prodigious efforts to create more model laws and a certification program, the GAO found serious perennial shortfalls in the actual examination and monitoring capabilities of State insurance commissions.

This preoccupation with adopting new standards has apparently been accompanied by an attitude of resignation about enforcing them when the going gets tough. As a result, resources which might better be spent on strengthening the detection and prosecution of violators have been directed toward establishing a thicket of additional rules which must be followed by companies that are inclined to obey them. People willing to flaunt the rulebook can operate with the comfort that their honest colleagues and the regulatory apparatus are busy digesting still more standards.

The Nebraska insurance director confirmed the enforcement weaknesses of State regulators in his testimony to the subcommittee. When asked what the States had done about Mr. Miro, he responded: "Our resources are limited." He later admitted: "The States have a very difficult time acting unilaterally trying to get their arms around somebody like Carlos Miro."

The NAIC's testimony disclosed that State officials have not used their own existing laws and regulations to pursue and punish of-

fenders such as Mr. Miro. They have instead relied on the Federal Government to investigate and convict violators using criminal fraud charges. Although opposing any direct participation by the Federal Government in regulating to prevent insurer insolvencies, the NAIC is boldly asking Congress to grant State regulators even more powers to act in areas where they have failed to exercise their current authority. The NAIC also joined in asking the Federal Government to expand its criminal laws to facilitate the punishment of people who violate the State regulatory system. Congress recently enacted such provisions.

Establishing sound regulatory guidelines on solvency is an important first step in correcting the problems identified by the subcommittee. However, the notion that gaps in the regulatory system can be plugged by simply fixing the rules is plainly erroneous. Until State regulators start emphasizing enforcement mechanisms that are aggressive and determined, the NAIC's focus on creating more standards will result in a flurry of activity that misses the underlying causes of insurance company insolvencies.

The subcommittee has found that regulatory systems work best when they operate with the presumption that clever people will try to either avoid or fool them. Regulators can then target their limited resources to enforcement against troublemakers, rather than issuing a continual stream of general application directives on the presumption that they will be uniformly obeyed. The certainty that there will always be rascality and incompetence in the insurance industry is all the more reason to make finding them the regulator's priority.

APPENDIX

Table 1 – Overdue Reinsurance on Paid Losses Owed to Insurers in the United States
1992 Reporting Year

Country	Total Reinsurance Owed to the United States	Reinsurance More than 6 Months Overdue	Percentage Exceeding 6 Months Overdue	Total 1992 Reinsurance Premiums from the United States
North Korea	$ 4,649,489	$ 4,168,616	90%	$ 25,710
Indonesia	2,444,568	2,180,890	89%	153,076
Venezuela	3,485,211	3,050,603	88%	17,378
Portugal	2,666,095	2,266,466	85%	140,421
Costa Rica	2,597,842	2,074,935	80%	16,228
Romania	3,575,725	2,827,093	79%	198,205
Argentina	11,630,139	8,885,166	76%	264,862
Uruguay	12,393,441	9,078,893	73%	545,273
China	23,458,484	17,136,015	73%	6,940,647
Brazil	16,778,571	10,920,336	65%	1,006,234
Channel Isles	3,187,196	2,069,011	65%	7,835,702
Singapore	11,039,976	6,934,454	63%	1,768,915
British Virgin Islands	9,924,938	5,857,445	59%	24,134,825

Continued next page.

Table 1 – Continued

Country	Total Reinsurance Owed to the United States	Reinsurance More than 6 Months Overdue	Percentage Exceeding 6 Months Overdue	Total 1992 Reinsurance Premiums from the United States
Israel	11,468,346	6,681,168	58%	393,129
Finland	37,659,559	20,251,366	54%	30,097,372
Spain	12,864,793	6,364,334	49%	13,575,777
South Korea	6,109,460	2,867,085	47%	7,120,785
Belgium	14,418,561	6,155,067	43%	21,585,867
Netherlands	8,447,074	3,591,351	43%	13,951,153
India	4,284,195	1,507,262	35%	4,894,457
United Kingdom	1,324,775,450	453,563,836	34%	2,705,380,953
Taiwan	7,495,575	2,538,583	34%	10,587,989
Mexico	4,807,179	1,533,938	32%	2,267,857
Canada	30,701,592	8,927,677	29%	247,113,229
Norway	6,987,727	1,863,310	27%	20,913,560
Bermuda	510,837,237	130,267,948	26%	3,496,306,783
Total	$ 2,088,688,423	$ 723,562,848	35%	$ 6,617,236,387

Source: NAIC Financial Reports Database

Table 2 – Responses to Subcommittee's Foreign Regulation Questionnaire

Country	Status of Response
Antigua	No Response
Argentina	No Response
Australia	Response Received 4–16–93
Austria	Response Received 4–13–93
Bahamas	Response Received 4–14–93
Bahrain	No Response
Barbados	Response Received 6–11–93
Belgium	Response Received 5–13–93
Bermuda	Response Received 5–17–93
Brazil	No Response
British Virgin Islands	Response Received 9–21–93
Canada	Response Received 4–21–93
Cayman Islands	No Response
Columbia	Response Received 4–27–93
Denmark	Response Received 6–14–93
Dominican Republic	Response Received 6–18–93
Finland	Response Received 6–29–93
Guernsey, Channel Islands	Response Received 4–8–93
Hong Kong	Response Received 4–12–93
Indonesia	Response Received 4–13–93
France	Response Received 5–12–93
Germany	Response Received 5–17–93
Greece	No Response
Ireland	Response Received 5–11–93
Isle of Man	Response Received 4–13–93
Israel	Response Received 4–28–93
Italy	Response Received 9–20–93
Japan	Response Received 4–16–93
Luxembourg	Response Received 10–1–93
Malaysia	Response Received 4–16–93
Mexico	Response Received 4–14–93
The Netherlands	Response Received 4–29–93
Norway	Response Received 4–26–93
People's Republic of China	No Response
Poland	Response Received 4–16–93
Portugal	Response Received 3–26–93
Romania	No Response
Republic of Singapore	Response Received 5–13–93
Republic of Korea	Response Received 7–14–93
Spain	Response Received 6–3–93
Sweden	Response Received 4–22–93
Switzerland	Response Received 6–17–93
Taiwan, Republic of China	No Response
Turks and Caicos Islands	Response Received 4–6–93
United Kingdom	Response Received 6–10–93
Uruguay	No Response
Venezuela	Response Received 8–12–93

Table 3 – Foreign Secrecy Laws and Disclosures to Regulators in the United States

Country	Do You Have a Secrecy Law?	Number of Disclosures to Regulators in the United States	Number of Requests from Regulators in the United States
Australia	No	3	3
Austria	No	0	0
Bahamas	Yes	"Not Available"	"Not Available"
Barbados	Yes	No Response	No Response
Belgium	No (1)	"N/A"	"N/A"
Bermuda	Yes	"N/A"	"N/A"
British Virgin Islands	No	"Approx. 2–3 times a week"	"Approx. 2–3 times a week"
Canada	No	0	0
Columbia	No	0	0
Denmark	Yes/No	0	0
Dominican Republic	No	"–"	"–"
Finland	Yes (2)	"–"	"–"
France	Yes	"/"	1
Germany	(3)	No Data	No Data
Guernsey	No	"Countless"	"Several"
Hong Kong	Yes (4)	No Statistics	No Statistics
Indonesia	No	"Unknown"	"Unknown"
Ireland	(5)	"Roughly" 10	"Roughly" 10

1) "No, but certain conditions have to be met."
2) "Yes, partly."
3) Cooperation agreements with non–EC countries possible.
4) Inquiring country must have adequate secrecy law.
5) "Have cooperated in the provision of information."

Continued next page.

Table 3 – Continued

Country	Do You Have a Secrecy Law?	Number of Disclosures to Regulators in the United States	Number of Requests from Regulators in the United States
Isle of Man	No	"A Number"	"A Number"
Israel	Yes	0	0
Italy	(3)	No Response	No Response
Japan	Yes	"N/A"	"N/A"
Korea	Yes	0	0
Luxembourg	Yes (6)	"/"	0
Malaysia	Yes	"N/A"	"N/A"
Mexico	No	0	0
Netherlands	Yes	0	0
Norway	No	0	0
Poland	No	"–"	"–"
Portugal	Yes	0	0
Singapore	Yes	"NA"	"NA"
Spain	(7)	"–"	"–"
Sweden	Yes (8)	0	0
Switzerland	Yes	"/"	"/"
Turks and Caicos (9)	Yes	"95%"	>=100
United Kingdom	No (10)	"Several"	"Several"
Venezuela	No	0	0

6) "Yes, with restrictions."
7) "Professional secrecy–reciprocity" with non–EC countries.
8) Yes, with regard to criminal records and business secrets.
9) Data on number of disclosures since January 1, 1990.
10) "Limited gateways" exist.

Source: Subcommittee Questionnaire

Table 4 – Availability of Key Information to Foreign Regulators and the Public.

Legend:
X = Some or all of the information in this category is routinely submitted to the regulator, but it is not available to the public.
NS = Information in this category is not routinely submitted to the regulator.

Country	Identity of Owners and Managers (a)	Identity and Relationship of Affiliates (b)	Loans, Investments of Company and Affiliates (c)	Purchases, Sales or Exchange of Assets (d)
Australia (1)				X
Austria (2)	X	X	X	X
Bahamas		X	X	X
Barbados	X	NS	NS	NS
Belgium (3)			X	X
Bermuda (4)		NS	NS	NS
British Virgin Islands		X	X	X
Canada	X	X	X	X
Columbia	X	X		X
Denmark (5)			X	X
Dominican Republic	NS	NS	NS	X
Finland (6)	NS	NS	NS	NS
France	X			X
Germany (3)				
Guernsey (7)	X	X	X	X
Hong Kong (8)		X		X
Indonesia	X	X	X	X
Ireland				
Isle of Man	X	X	X	X
Israel		X	X	X
Italy (9)		X	X	X
Japan	X	X	X	X
Korea (10)	X	X	X	X
Luxembourg		X	X	X
Malaysia	X	X	X	X
Mexico			X	X
Netherlands	X			
Norway	X	X	X	X
Poland		X	X	X
Portugal		X	X	X
Singapore (10)	X	X		X
Spain (6)			NS	NS
Sweden			X	NS
Switzerland (11)	NS	X	X	X
Turks and Caicos (3)		X	X	X
United Kingdom (12)	X	X		
Venezuela			X	

Source: Subcommittee Questionnaire

1) Table shows requirements for life companies. For property/casualty, (b), (c), (f), (g), (h) and (i) are submitted routinely to the regulator. (e) is submitted on request. (g), (h) and (i) are available to the public.
2) (a) is submitted for managers only. (c) and (d) are submitted in summary form. Neither (a), (c), nor (d) are available to the public.
3) For (a), information on owners and managers is submitted, but only information on managers is available to the public.
4) (b) through (g) are submitted to the regulator upon request. They are not publicly available.
5) For (a), information on managers only is submitted. It is publicly available.

Table 4 – Continued

Management, Service and Cost-Sharing Agreements (e)	Reinsurance Agreements (f)	Dividends and Other Distributions to Shareholders (g)	Balance Sheets (h)	Revenues and Income (i)	Changes in Financial Position or Cash Flow (j)
X	X				NS
X	NS				X
X	X	NS	X	X	X
NS	X	X	X	X	NS
NS	X				
NS	NS	NS	X	X	NS
X	X	X	X	X	X
X	X	X	X	X	X
X	X	X			
X	X				X
NS	X	X	X	X	X
NS	NS	NS			
X	X				
X	X				
NS	NS	X	X	X	X
					NS
X	X	X	X	X	X
X	X				
X	X	X	X	X	X
NS	X				
NS	X			X	X
X	X	X	X	X	X
X	X	X			NS
X	X	X			X
X	X				
X	X				X
X	X				
X	X				
X	X	X		X	X
X	X				
X	X	X			
NS	NS				
NS	NS				
X	X				
X	X	NS	X	X	X
X					
X	X	X			X

6) (c) through (f) are submitted to the regulator upon request. They are not publicly available.

7) (e) and (f) are submitted upon request. They are not publicly available.

8) (a) is submitted to regulator. Identity of shareholders and company secretary only are publicly available.

9) (c) and (d) are submitted to regulators in some cases, but are not available to the public. (g) part of balance sheet. Balance sheet is available to the public, but in less detail than submitted.

10) (e) is not reported for affiliates.

11) Regulator's response unclear on (j).

12) (c) is reported in total. (d) is reported in aggregate only. Both are available to the public.

Table 5 – Foreign Regulatory Authority Over Holding Companies and Affiliates

Legend: X = Regulator does not have this authority. NR = No Response.

COUNTRY	Complete Access to Affiliate Records	Require Routine Disclosure of Identity and Relationship of Affiliates	Prior Regulatory Approval of Affiliate Transactions
Australia			X
Austria	X		X
Bahamas			(2)
Barbados		X	NR
Belgium			X
Bermuda		X	X
British Virgin Islands			X
Canada	X		(3)
Columbia			X
Denmark			(3)
Dominican Republic	X	X	X
Finland		X	(4)
France			X
Germany			X
Guernsey	X		X
Hong Kong	X		X
Indonesia	X		
Ireland			(7)
Isle of Man	X		X
Israel			
Italy	X		(8)
Japan	X		X
Korea	X		
Luxembourg			
Malaysia	X		
Mexico			
Netherlands	X		(9)
Norway			X
Poland			X
Portugal	X		X
Singapore	X		X
Spain			X
Sweden			X
Switzerland	X		X
Turks and Caicos			X
United Kingdom	X		X
Venezuela			X

Source: Subcommittee Questionnaire

1) Yes, limited.
2) Yes, at regulator's discretion.
3) Yes, in some cases.
4) No, if within the limits set by legislation.
5) No, the legislative restrictions apply.
6) Yes, partly.
7) Yes, when solvency is affected.
8) Yes, but requirement has not yet been approved.

Table 5 – Continued

Prior Regulatory Approval of Extraordinary Dividends	Legal Authority to Identify Owners and Controllers of Insurance Companies	Legal Authority to Require Disclosure of Ultimate Controllers of Insurance Company	Legal Authority to Investigate Activities of Ultimate Controllers of Insurance Company.
X	X		(1) X
X			
NR		NR	NR
X			
X			
X			X
X			
X		X	
X			
(5)			(6)
X			
X		X	X
X			X
X			X
X			
X			X
X			
X			
X			X
X		X	X
		X	X
X			X
X			
X			X
X			X
			X
X			(10)
(11)			X
X	X	X	X
X			
(12)		X	X

9) Yes, sometimes.
10) No, except in some situations.
11) No, for non–life. Dividends not permitted for life companies.
12) Appointed actuary must attest that assets exceed liabilities. Profits are normally distributed on a 90/10 ratio, policyholders to shareholders. If ratio will vary more than .5%, DTI must be notified.

MINORITY VIEWS

Since this subcommittee issued *Failed Promises* in early 1990, much has changed in the regulation of the insurance industry. That report highlighted some problems in the State system of insurance regulation and posed a number of important questions for regulators at all levels. *Failed Promises* acted as a catalyst to mobilize the various State regulatory authorities, voluntary organizations, and private industry groups to find new ways of dealing with the existing weaknesses of the State regulatory system which are discussed in *Wishful Thinking*. This outcome demonstrated the kind of constructive role that the subcommittee can play in oversight of the insurance industry.

Since that time, Congress continued its examination of the current and future status of insurance regulation. Committees in both the House and Senate pursued their oversight of State insurance regulators, the National Association of Insurance Commissioners (NAIC), and individual insurance companies. The Subcommittee on Commerce, Consumer Protection and Competitiveness held several hearings on a legislative proposal for a Federal insurance regulator that would create a new Federal bureaucracy and a new Federal guaranty fund for insurance policies. None of these efforts, however, generated enough consensus to move any serious attempt at Federal regulation of the insurance industry out of the hearing stage.

The chairman of the full committee recently announced his intent to circulate a new proposal for the Federal regulation of the insurance industry. While the Majority assures us that the forthcoming legislation and this report are in no way directly linked, the proximity of the chairman's announcement and the subcommittee's consideration of this report cause us some concern.

We want to emphasize that the subcommittee's 6 year investigation of insurer solvency has been conducted in a bipartisan fashion and the Minority staff has been fully involved in all phases of that investigation. Further, we believe that *Wishful Thinking* identifies a number of continuing weaknesses in the present structure of insurance regulation. We share the Majority's concerns about the consequences of major insurance insolvencies and believe that those concerns should be addressed.

However, we do not agree with the implicit conclusion underlying the Majority report. While never directly advocating a broad Federal regulatory presence in the insurance industry, *Wishful Thinking* implies that a strong Federal regulator is the only possible answer to the continuing woes of State regulatory authorities. We not only substantively disagree with this conclusion, but also are uncomfortable with this effort to go beyond the subcommittee's oversight activities into essentially making legislative recommenda-

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tions. It is for these reasons, and with great regret, that we must respectfully dissent with the Majority.

Concluding that Federal regulation of the insurance industry represents a panacea for weaknesses in the existing regulatory arrangement constitutes its own form of "wishful thinking." Federal regulatory bodies tend to be expensive, self-perpetuating, and have a mixed track record of preventing the kinds of abuses outlined in *Failed Promises* and *Wishful Thinking*. Also, Federal bureaucracies tend to be unresponsive to the real needs of consumers and small businesses. There are other regulatory options, all with varying degrees of Federal involvement, that could achieve the same kinds of reforms sought by the Majority. It is the purpose of these Minority views to provide an alternative viewpoint to the one contained in the Majority report, and demonstrate that there are other viable alternatives for improving regulation of the insurance industry.

OBSERVATIONS OF THE REPORT

The Majority report reached a number of explicit conclusions about the effectiveness of insurance regulation by the States. While many of these address specific problems in the existing system that need to be examined, we cannot agree with those conclusions or recommendations that inevitably lead to the creation of a Federal regulatory body.

The report makes two broad criticisms that are worthy of note in this respect. First, the report states that State regulators either fail to anticipate illegal or inappropriate behavior or otherwise fail to thwart inappropriate behavior before it occurs. Second, the report contends that State regulators and the NAIC lack the authority necessary to effectively regulate the insurance marketplace. While the sections of the report detailing these criticisms do identify problems and areas for legitimate concern, a Federal regulator is not the only viable solution. We deal with both of these general concerns individually below.

Criticism No. 1: State Regulators Fail to Effectively Anticipate Illicit Behavior or Act to Stop It

On this point, we agree with the Majority that this is an ongoing problem. In many of the cases studied by the subcommittee, criminal acts could have been stopped before they occurred if State regulators were monitoring insurers with an eye to fraudulent activities or management inconsistent with an insurer's responsibility to its policyholders.

Regulating solely for the "good guys" in the industry is not sufficient. In order to be effective, regulators must operate with the dishonest company or individual in mind, particularly when regulating an industry in which millions of dollars routinely change hands.

However, to suggest either implicitly or directly that State regulators are unable to meet this challenge fails to give them proper credit. Likewise, we cannot automatically assume that the Federal Government will succeed where the States have not. For example, the Carlos Miro case study was discussed prominently in *Wishful Thinking*. During his testimony before the subcommittee, Mr. Miro asserted that Federal penalties imposed by Federal regulators

make criminals think twice before acting, giving the impression that Federal regulation of the insurance industry would discourage behavior such as Mr. Miro's.

Unfortunately, such an assertion does not comport with reality. Mr. Miro was a criminal, plain and simple. First, Mr. Miro was testifying before a Congressional committee one week prior to his sentencing. It was evident from both his testimony and his exploits that Mr. Miro was willing to do anything or say anything so long as he was the one to benefit. There is no reason to believe that he would not continue the same behavior even after he had been caught.

Second, and most importantly, Mr. Miro was extremely bright, but his character was such that he believed that his gifts were put to better use by trying to get around the system than working within it. There is nothing to suggest, aside from Mr. Miro's own questionable opinion, that the presence of a Federal regulator would have done anything to discourage Mr. Miro. The strong regulatory presence of the Securities and Exchange Commission, a Federal regulatory authority, did little to discourage Michael Milken's exploits. That is because Mr. Milken and Mr. Miro share a single character trait—they are criminals, and will always try to work around the system, no matter who regulates it.

This is not to imply that there is no room for improvement. We were pleased to see that the NAIC's suggestion that interstate insurance fraud be made a Federal crime was included in the recently enacted crime bill. We believe that Federal and State law enforcement authorities should do a better job of working together. The Federal Bureau of Investigation and the U.S. Attorneys' offices should serve as a resource to State regulators who might otherwise be hampered in their investigations and prosecutions of interstate insurance fraud. State and Federal authorities should work in concert to ensure the protection of policyholders, not to the exclusion of one another.

State regulators should also improve their ability to ferret out wrongdoers and pursue criminal convictions more vigorously. One way that States can mute calls for Federal regulation of the insurance industry is by taking a more active role in finding and prosecuting criminals, working with Federal authorities when necessary.

Criticism No. 2: State Regulators and the NAIC Lack the Regulatory Authority Necessary to Regulate the Insurance Industry

The other major criticism of *Wishful Thinking* is that insurance regulators lack the authority to regulate the very companies and individuals involved in illicit behavior. In the case of State regulators, the Majority report contends that they entirely lack the authority to regulate insurers and reinsurers from other countries, and generally lack sufficient authority and resources to monitor insurers outside their State borders. In the case of the National Association of Insurance Commissioners (NAIC), the report states that it has no legal authority at all, but is simply a voluntary organization whose members happen to be State regulators. We agree with both of those criticisms.

Despite these handicaps, we must note the progress made by State regulators and the NAIC through the accreditation program. Nearly every State has taken steps to meet the NAIC standards and 38 States have been accredited by the NAIC as meeting those standards. However, the inability of States to directly regulate the solvency of insurers outside their borders continues to place policy holders at risk. Thus far, attempts by the NAIC to create a set of minimum national solvency standards have not achieved the desired level of consistency or stringency. It is easy to see how someone could jump to the conclusion that substantial Federal intervention is required if the situation is to be corrected.

However, that is not the only possible conclusion. Certainly State regulators are lacking some authority at this time which arguably is necessary to the proper regulation of the insurance industry. Federal involvement, particularly with respect to insurers and reinsurers domiciled in other countries, is necessary to provide the requisite additional authority. However, just because some Federal action is required does not mean that a Federal regulator is required.

Just as the McCarran–Ferguson Act delegated the duty of insurance regulation to the several States, the Federal Government has the right to provide State regulators with whatever authority the Congress deems necessary to carry out those responsibilities. That authority could be delegated to the NAIC, a Federal authority, or some other entity which does not yet exist. Many of the commonly discussed approaches to this problem are addressed later.

The GAO concluded that the NAIC is not the right entity for the job. We believe that excluding the NAIC from the list of possible alternatives to a Federal takeover of the regulation of insurance is unwise. The NAIC has proven it has much to offer and is the only national body with extensive expertise and experience in the regulation of the business of insurance.

We believe that, given the proper authority, State regulators and the NAIC can be effective in their efforts to achieve more meaningful reform of insurer solvency standards. To dismiss them outright, as this report appears to do, leads one to the erroneous conclusion that Federal regulation is the only possible option. Such a result is neither desirable nor constructive.

OPTIONS FOR IMPROVING THE STATE SYSTEM

Wishful Thinking sets forth three core goals of a successful solvency regulation program: (1) uniform national minimum solvency standards, (2) meaningful enforcement, and, (3) controlling alien insurers and reinsurers. These are important goals for such a program. However, we believe that each can be best met by strengthening, not dismantling, the current State regulatory system.

As mentioned previously, we do not believe that a Federal regulator is required to achieve these goals. A few of the alternative options are presented below. We are not endorsing any one over the other, but are simply presenting them for the purposes of a full and open debate.

The Expanded NAIC Model. Solvency regulation under this model would be structured similarly to the current accreditation program, but the NAIC would be given the requisite authority to address the problems found in *Wishful Thinking*. The NAIC be-

lieves that it needs additional authority from the Federal Government, particularly with respect to the registration of foreign insurers and reinsurers, before it can operate to its fullest potential. We believe that it would be both necessary and appropriate for Congress to act to ensure that the NAIC has the necessary tools to fix existing problems in solvency regulation.

This option could possibly address many of the problems raised in *Wishful Thinking* without the need for a new Federal bureaucracy. While steps would have to be taken to ensure that some of the NAIC's current problems do not carry over into the new regulatory structure, this option is the option that would be the closest to keeping the current system in place while eliminating some of its shortcomings.

The Interstate Compact Model. An interstate compact can be best defined as an agreement between two or more States, entered into for the purpose of addressing a particular problem that transcends State boundaries. In the area of insurance solvency, the separate efforts started by the Midwestern Zone working group of the NAIC and the National Conference of Insurance Legislators (NCOIL) have converged into a single proposal governing rehabilitation, liquidation, and conservation. In addition, the Midwestern Zone group is developing a proposal for the registration of alien insurers and reinsurers.

Currently, these proposals are being studied by an NAIC study group which will issue its report by the end of this year. Presumably, if there is a positive recommendation, the States could begin the process of entering into these compacts soon thereafter.

Although some argue that the States already have the authority required to form an interstate compact for the regulation of insurance, many believe that the Congress, pursuant to the compact clause of the Constitution, would have to give its consent before such a compact would be permitted. All this would require is a sense of the Congress resolution indicating the Congress' approval for such a compact.

Advocates of the interstate compact believe that it provides the kind of unified, national approach to solvency regulation recommended by *Wishful Thinking* without the associated expense and bureaucracy of a brand new Federal agency. Further, it builds upon the only existing expertise in insurance regulation in the United States, the State regulators and the NAIC. In short, the interstate compact thus far represents the most comprehensive alternative to either the current system or Federal regulation.

The Federal Minimum Standards Model. Another criticism leveled by *Wishful Thinking* is that State regulators have difficulty developing and implementing consistent, meaningful uniform national standards. If one believes that the existing mechanisms, primarily the NAIC's accreditation program, have failed to achieve the desired results, then one possible conclusion is that a more substantial Federal role is required to achieve uniformity. One model for this is the Federal minimum standards model, similar in structure to the model used in developing Federal minimum standards for Medigap policies.

Under this model, Congress would charge the NAIC (or some other organization with the necessary expertise) with developing

the Federal minimum standards. The Secretary of Commerce would have the necessary oversight authority, and the ability to approve or disapprove the NAIC's final product. If the Secretary approved the NAIC's package of minimum standards, the standards would become applicable across the Nation. If the Secretary disapproved the NAIC's package, then the Secretary would have the authority to develop a Federal minimum standards package and those standards would become the minimum standards to be enforced by the States. A provision could be worked into the legislation to permit periodic consultations between the Secretary and interested parties on the continued effectiveness of the minimum standards package and the need for any amendments to the package.

This model creates a larger oversight role for the Federal Government, but still does not necessitate the creation of a new Federal regulatory agency. The cost to the government would be minimal, since much of the work is being done by other organizations. It would create a regulatory floor below which no State could lower its own standards, but States would be free to raise them as high as they desire. This could create the base of national uniformity sought by many both in the insurance industry and in the regulatory community.

CONCLUSION

Wishful Thinking, like *Failed Promises,* identifies a number of continuing weaknesses in the present insurance solvency regulatory structure. The Minority shares the Majority's concern about the potential impact of a widespread insurance solvency crisis on American consumers. We supported *Failed Promises* because that report asked the questions that needed to be asked and succeeded in mobilizing the insurance industry and State regulators to address their shortcomings. However, by implying that a broad Federal role is the only possible answer to the regulatory problems observed by the subcommittee, *Wishful Thinking* goes beyond the bounds of legislative oversight into the promotion, albeit surreptitiously, of a legislative remedy that we cannot support.

Clearly, however, the subcommittee's record does indicate that further changes are needed in the current insurance regulatory regime. We outlined some of the options for reform above. Whether or not any of those options are adopted, we believe that there are a number of things that must be accomplished if the continued survival of the State regulatory system is to be ensured.

First, the States must continue their efforts to strengthen insurance solvency regulation. If they fail to continue on the path they began after the release of *Failed Promises,* they must accept the fact that Federal preemption is inevitable. We cannot continue to defend the States if it is to the ultimate detriment of the Nation's consumers.

While we understand the concerns of some State government officials regarding the NAIC's self-appointed role as the arbiter of the quality of national solvency standards, they must understand that the NAIC is currently one of the few deterrents standing between them and a complete loss of State sovereignty on the issue of insurance solvency. The States must understand that the NAIC has an

important role to play in ensuring the solvency of the Nation's insurance companies.

We want to commend the NAIC for being fully cooperative with the subcommittee and GAO in their investigations. It has opened its files and meetings to investigators year after year and has produced reams of documentation in response to requests by the subcommittee and the GAO.

We freely acknowledge that the NAIC suffers from the faults endemic in a State regulatory system, but we also believe that it has much to offer. That is why we have expressed our dismay in the past that, despite all of the GAO's criticism of the NAIC, GAO has been unwilling to make specific recommendations for improvements that could be made by the NAIC.

Second, Congress has long delegated its authority over the insurance market to the States. Even in the absence of recommendations from the GAO or others, we believe that Congress should take the steps necessary to see that the States have whatever additional powers are necessary to regulate today's insurance industry. If the States choose the route of an interstate compact, then Congress should grant permission for them to do so. If they seek to have regulatory authority vested in another body, Congress should also be willing to act on the States' request.

We also believe that the Federal Government should assist States in pursuing and prosecuting insurance criminals. To that end, we were pleased to see Federal insurance fraud provisions included in the recently enacted crime bill.

Finally, Federal and State law enforcement authorities should do a better job of working together. The Federal Bureau of Investigation and the U.S. Attorneys' offices should work in conjunction with State regulators to ensure that America's consumers are protected from insurance frauds and cheats.

In sum, we must underscore that we are in agreement with many of the specific criticisms detailed in *Wishful Thinking*. However, we believe that when the report is taken as a whole and placed into the current political and regulatory context, it sounds too strong a call for Federal regulation of the insurance industry.

The creation of a Federal regulator is but one of the options available to the Congress. Interstate compacts, an expanded role for the NAIC, and Federal minimum standards enforced by the States are also viable options. We strongly believe that all of these options should be thoroughly debated by the relevant legislative subcommittees before coming to any conclusion.

Our final message, however, is this: *Wishful Thinking* should once again serve as a wake up call to the States and the industry that we are serious about real regulatory reform in the insurance industry. The States need to move quickly and decisively to remedy the problems found by this subcommittee and others. We believe that the Congress can serve a constructive role in this process, and hope that the States will adopt measures to address those shortcomings found in this report.

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