NATIONAL CONFERENCE OF INSURANCE LEGISLATORS
FINANCIAL SERVICES & INVESTMENT PRODUCTS COMMITTEE
WASHINGTON, DC
FEBRUARY 28, 2008
MINUTES

The National Conference of Insurance Legislators (NCOIL) Financial Services & Investment Products Committee met at the Hyatt Regency on Capitol Hill in Washington, DC, on Thursday, February 28, 2008, at 11:40 a.m.

Assem. Ivan Lafayette of New York, chair of the Committee, presided.

Other legislators present were:

- Sen. Bill Brady, IL
- Rep. George Keiser, ND
- Rep. Frank Wald, ND
- Assem. Joseph Hardy, NV
- Sen. Neil Breslin, NY
- Assem. Nancy Calhoun, NY
- Sen. William J. Larkin, Jr., NY
- Assem. Joseph Morelle, NY
- Rep. Anthony Melio, PA
- Rep. Hubert Vo, TX
- Rep. Warren Kitzmiller, VT

Also in attendance were:

- Susan Nolan, Nolan Associates, NCOIL Executive Director
- Candace Thorson, NCOIL Deputy Executive Director
- Mike Humphreys, NCOIL Director of State-Federal Relations
- Jordan Estey, NCOIL Director of Legislative Affairs & Education

MINUTES

The Committee voted unanimously to approve the minutes of its November 15, 2007, meeting in Las Vegas, Nevada.

IRS REGULATIONS FOR CAPTIVE INSURANCE COMPANY RESERVES

Mark Smith of the United States Department of the Treasury described a proposed regulation regarding taxation of transactions between captive insurance company members—which he said are related corporations that file a single income tax return. He noted that existing regulations have tax exemptions for these transactions and that the proposed regulation would have removed these exemptions. He said the regulation would have placed captive transactions on the same level as most other similar transactions between members of a group in cases where the provision of insurance between members constituted a "significant portion," which, he said, would be a benchmark of five percent of premiums.

Mr. Smith reported that after receiving public comments, the Department withdrew the proposed changes and cancelled a planned public hearing. He mentioned that the comments warned of a negative effect on state captive insurance industries should the regulation go into effect, including that captive insurers could move their businesses off-shore. He said that the regulation was not intended to be anti-captive but rather to improve accounting methods.

SOX-RELATED CORPORATE GOVERNANCE INITIATIVES

Ohio Insurance Director Mary Jo Hudson said the National Association of Insurance Commissioners (NAIC) had adopted amendments to its model audit rule, or its *Annual Financial Reporting Model Regulation*, in June 2006 that would address auditor independence, corporate governance, and internal controls over financial reporting. Contrasting the amendments with federal *Sarbanes-Oxley Act* (SOX) requirements, she stated that the model audit rule is more limited in scope and only applies to companies with over $500 million in annual premiums. She added that companies already complying with SOX could submit the SOX reporting information to state insurance departments.

Director Hudson reported that two states have adopted the amendments and that others would look to implement changes before January 1, 2010. She said that because the amendments would revise an existing accreditation standard, the NAIC had published the amendments for public comment throughout 2008. She said the Financial Regulation Standards and Accreditation (F) Committee would review the amendments as a change to the accreditation standard in early 2009.

Responding to a question from Rep. Keiser regarding problems the amendments sought to address, Director Hudson said the auditor independence amendment would ensure that audits are conducted objectively, and the corporate governance amendment would require the creation of an audit committee so that management was not the only group reporting to the auditors. She added that internal controls changes would encourage more proactive regulatory reviews, instead of incidence-based efforts.

Joe Thesing of the National Association of Mutual Insurance Companies (NAMIC) expressed opposition to the amendments and said that Congress never intended for SOX to apply to non-public insurance companies. He said SOX was designed to benefit public company investors.

Mr. Thesing said NAMIC had concluded that the changes could ultimately impose added costs of between $80 to $100 million on insurance companies. He cited an NAIC survey of state insurance departments that, he said, showed that departments in 28 states planned to pursue the model audit rule through a regulatory process, and 17 planned to pursue legislation. He stated that the NAIC planned to make the amended model audit rule an accreditation standard even though no state legislature had approved it.

Assem. Lafayette questioned why NAMIC would not support complete audits of company reserves and financial investments. Mr. Thesing replied that NAMIC strongly supported internal controls but had opposed NAIC mandates for specific types of internal controls.

Responding to a question from Assem. Calhoun, Mr. Thesing clarified that the $80 to $100 million cost on insurance companies would apply industry-wide, not to individual companies.

NAIC SECURITIES VALUATION OFFICE (SVO)

Chris Evangel of the NAIC SVO said the SVO was working on initiatives regarding securities pricing and transparency, among other things. He reported that the pricing initiative would allow insurance companies to price securities using a variety of methodologies and noted that by the Spring of 2009 the SVO would provide pricing benchmarks for regulators to use in evaluating the securities. Regarding transparency, he said that a new initiative provided for the public dissemination of publicly rated securities for which the SVO had issued a rating opinion or credit assessment.

Mr. Evangel further reported that the SVO continued to monitor a variety of credit issues and activities within the financial marketplace. The SVO, he said, had produced a report that identified the subprime exposure of many insurance companies.

Responding to a question from Rep. Keiser, Mr. Evangel answered that the SVO did not look at mortgage-backed securities that are publicly rated. He mentioned that the SVO reviews its database and evaluates insurance company holdings and cautioned that commercially backed mortgages could be the next big issue.

John Gerni of the American Council of Life Insurers (ACLI) commented that an NAIC Invested Asset Working Group (IAWG) had released a report regarding hybrid security classification on February 5, 2008. He said the report did not complement an American Academy of Actuaries (AAA) report on how to address hybrid classification, and he stated that several of the report's proposals were not publicly discussed. He reported that the ACLI was not convinced that transparency existed in the NAIC-SVO classification process and said that the life insurance industry disagreed with the NAIC that hybrid security classification issues have been resolved.

Responding to a question from Assem. Lafayette regarding insurance company investments, Mr. Gerni said that the ACLI was not convinced that the classification issue would be resolved by the end of 2008 and that ACLI was concerned that classification may revert to a 2006 scenario, which classified hybrids more as common stocks. He said a tentative agreement had been reached, and extended to the end of 2008, that would classify a hybrid security as preferred stock with the understanding that the bond would be classified "a notch below" its true classification.

Rep. Keiser asked for a definition of a hybrid security. Mr. Evangel said a hybrid security pays a fixed interest payment like a typical bond, but gives discretion to the issuer to defer those payments—acting, he said, like a stock or an equity. He commented that there was a difference between transparency and non-agreement, and said the SVO process was very open.

FEDERAL IDENTITY THEFT ACTIVITY

Betsy Broder of the U.S. Federal Trade Commission (FTC) said the President had designated an identity theft task force a few years ago to develop a coordinated plan to address the issue. She reported that the task force plan was directed at four key areas that included (1) keeping sensitive data out of thieves' hands through better data security; (2) making it more difficult for thieves to use data, if obtained; (3) assisting victims in recovery; and (4) deterring crime through aggressive law enforcement and sentencing.

Ms. Broder reported that the task force was looking for a balanced approach that would allow the beneficial and deeply imbedded use of Social Security numbers (SSN) to continue, but prevent their general use as authenticators. She said the FTC had developed a comprehensive record of private sector SSN use and had received more than 300 public comments when it requested input on SSN utilization and the cost of switching to other identifiers. She commented that the FTC would issue future reports to the White House on recommendations to restrict the use of SSN.

Julie Gackenbach of Confrere Strategies, representing NAMIC, thanked the FTC for recognizing that the insurance industry has a special, ongoing need to use SSN information for authentification and fraud prevention purposes—regardless of any general ban on authentification. She then stated that the FTC had requested comments on the impact of federal credit freeze legislation. She said the insurance industry believes that it is important to have continued access to credit report information and to apply a consistent national standard.

BOND INSURER DOWNGRADES

Chris Evangel of the NAIC SVO reported on SVO efforts to assess the financial stability of bond insurers exposed to subprime lending failures—particularly in light of recent rating agency reviews regarding the current suitability of bond insurer ratings. He said the SVO had confirmed most rating decisions, noting that some insurers remained at AAA status while others were downgraded to AA. Mr. Evangel commented that bond insurance is important for local municipalities and added that most states do not need coverage because their credit ratings are sufficient. He said the remaining question is whether the market will still value AAA ratings as it had previously.

Robert Mackin of Mackin & Company, representing the Association of Financial Guaranty Insurers (AFGI), emphasized that the issue was not one of bond insurer solvency but rather whether bond insurers will be able to maintain their AAA or AA ratings. He said that companies were taking whatever steps necessary to maintain their ratings and to protect policyholders, including issuing equity and acquiring reinsurance.

Mr. Mackin reported that the bond insurance industry began in 1971 and has insured more than $3 trillion of asset-backed securities and municipal bonds. He said that since 1971 no holder of insured paper has ever failed to receive payment on time. He noted that of the 15 U.S. companies that are AAA rated, many are bond insurers.

SUBPRIME MORTGAGE LENDING

Julia Gordon of the Center for Responsible Lending (CRL) said that a CRL study had reported that home foreclosures were affecting the values of neighboring homes, noting that the report estimated that foreclosures had eroded approximately $200 million in such values. She cautioned that the worst is yet to come in the homeowners market and cited a recent Fitch report that estimated that 47 percent of outstanding subprime loans originating in 2006 would default. She commented that while the market is correcting itself, 2007 data revealed that of subprime loans originating since the beginning of the crisis, 69 percent still had adjustable rates and 40 percent did not require any documentation of income.

Ms. Gordon reported on federal initiatives, including a push from the Administration for voluntary loan modification by servicers, a Treasury Department effort to create a template modification for some of the most common products, and legislation to amend the bankruptcy code to permit bankruptcy judges to modify the terms of home loans.

ADJOURNMENT

There being no further business, the meeting adjourned at 12:40 p.m.

K:/NCOIL/2008 Documents/2005851a.doc