

Issue Brief

Evaluation of Costs and Benefits: The NAIC's Proposed Internal Control Reporting Provisions

Introduction

Crucial differences between public and mutual insurers cause NAMIC to oppose the NAIC's proposal to embed in state insurance regulation the expensive and burdensome provisions on financial disclosure found in Section 404 of the Sarbanes-Oxley Act of 2002. These provisions, as proposed for addition to the NAIC's Model Audit Rule, were intended by Congress for public companies and not for mutual insurers. NAMIC submitted this study to the NAIC to distinguish mutual insurers' record in relation to insolvencies and related facts and to emphasize the cost consequences of the Section 404 requirements.

Section 404 requires 1) that an insurer's management document and assess the effectiveness of the company's internal accounting control over financial reporting and 2) that the insurer's independent auditor provide an attestation on the accuracy of management's assessment of the adequacy of the internal control. Both of these steps require highly material additions to non-public insurers' resources allocated to financial reporting. This burden will fall disproportionately on smaller mutual insurers.

NAMIC members' reservations with this proposal arise from both the different motivations between public and mutual insurers and the corresponding minimum of failures among mutual insurers. The estimated costs of implementing the Section 404 material prompted NAMIC to commission a study of the costs and benefits of this proposal.

Findings

NAMIC's study, conducted by Finnell & Company, PLLC, examines the costs and potential benefits that would be experienced by mutual insurers in complying with the 404 prescriptions. It also abstracts from a number of respected sources to provide perspective to regulators on mutual and public insurers' past involvement with financial restatement and insolvency.

Among findings and conclusions of the NAMIC study are the following:

- Implementation would cost almost eight times the maximum potential benefit – elimination of all mutual insolvencies. This assumes a highly improbable “best-case” scenario since nearly all failures result from insufficient financial reserves or inadequate rates, not misreported financial statements.
- For mutual property/casualty insurers, year-one of compliance with Section 404 costs would exceed \$300 million, equal to the cost of all mutual insolvencies since 1992. Policyholders would ultimately bear these costs.
- Since 1991, mutuals' share of total insolvency costs has been only 5 percent of the industry total, despite mutuals representing approximately 33 percent of total property-casualty insurance premiums.

- The real benefits of the federal Sarbanes-Oxley Act's Section 404 relate to the minimization of reputational risk and the related impact on a publicly-traded company's stock price. This is relevant only for shareholders of public companies, where managements can be subject to those incentives or pressures that resulted in the financial reporting misstatements that impelled Congress to pass the Act.
- Small mutual insurers would experience a disproportionate burden from compliance with the proposal to add Section 404 requirements to state regulation.
- For public companies already adopting, estimated costs of compliance with Sarbanes-Oxley greatly exceed earlier estimates. Grafting elements of the Act onto existing state insurance solvency law will produce fewer benefits at great cost. This finding is confirmed by the cost-benefit analysis.

Conclusions

The solvency record of mutual insurers does not justify transfer of an expensive regulatory measure intended for investor-owned entities into state insurer-solvency regulation.

There has been no specific identification of regulatory failure and corresponding remedy during

NAIC deliberations on this matter. Reasonable regulation reconciles its costs with the potential for benefits.

Insurers, consumers, and regulators have a shared interest in promoting insurance company solvency. Meaningful efforts to strengthen solvency regulation should be based on a three-step evaluation that would include:

1. A detailed study of the causes and effects of insurer insolvencies across the country. To the extent possible, the study should make use of existing data and source material collected by state insurance departments, and should avoid focusing on a single jurisdiction.
2. An examination of the existing body of financial regulation law to identify what shortcomings, if any, can be linked to recent insolvencies.
3. Development of targeted, cost-effective remedies to address the identified weaknesses.

Until this evaluation is complete, state regulators and legislators should reject proposals to apply investor-oriented protections to non-public companies, particularly through revisions in the NAIC Model Audit Rule, leaving companies free to adopt provisions of the Act voluntarily, as indeed many have.