

Issue Brief

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NAIC Alternate SOX Proposal Remains Problematic

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Executive Summary

Significant developments have occurred in the efforts by the National Association of Insurance Commissioners (NAIC) to extend the Sarbanes-Oxley (SOX) Act's Section 404 content on internal control to mutual insurers via the NAIC's Model Audit Rule (MAR).

The original proposal was dropped from consideration in early November and an alternate proposal developed by some in the industry was adopted by an NAIC sub-group in December. Under the alternate proposal, estimated first-year compliance costs for non-public insurance companies would fall from about \$300 million to about \$80 million.

A new, higher exemption threshold (see below) spares most property-casualty companies altogether from any increased audit burden and accompanying costs. The new proposal will be considered in March by the NAIC/AICPA Working Group, the committee which thus far has been the forum for adding SOX content to the NAIC's MAR. Despite these improvements, NAMIC remains opposed to the proposal.

Background

Salient provisions and requirements of the alternate proposal include:

- A \$500 million threshold for application of the alternate proposal. Indexing of that amount for inflation or economic growth is under discussion. About 24 NAMIC mutual members would currently be affected.
- An implementation guide – similar to SEC rules made for implementation of the Sarbanes-Oxley Act. Such an implementation guide may be a source of later regulatory mischief and add to the burden of any SOX-related proposal that may survive.
- As part of annual regulatory financial reporting, management's representation that a system of internal control is extant and functioning. (No specific prescription for an internal control framework is made, and insurers have latitude to assemble their own such structure.)
- Management's representation as part of regulatory financial reporting that, to the best of its knowledge, the entity's system of internal control is effective, plus a statement how that evaluation is made.

- Disclosure of any unremediated (at year's end) material weaknesses in internal control made to the domiciliary regulator on an affirmative basis and to be treated confidentially – although such confidentiality is understood to be problematic in many states. Use of the “material weakness” criterion for this disclosure represents a loosening, in terms of the Model Audit Rule’s current prescription, of such communication of reportable problems with internal control. Companies would still have to keep information on significant deficiencies available for financial examiners, but this more exacting disclosure would not be part of annual reporting.

The \$500 million exemption threshold would reduce application of the alternate proposal to approximately 190 non-public companies, the premium of which, when combined with that of public insurers, would result in coverage of approximately 90 percent of the insurance industry’s total premium.

Procedural Considerations

The chair of the NAIC/AICPA Working Group has said that the alternate proposal will eventually be packaged with other, less offensive material from the Act’s provisions on auditor independence (Title II) and corporate governance (Title III). Such combination is intended to enhance chances of passage in superior committees.

Further deliberation within the NAIC is less certain to yield results sought by proponents of adding the Act’s internal control content, although those proponents believe they can push the package through the NAIC later this year. Should it survive in some form, it would likely not constitute a requirement for insurers until 2009 or 2010, given the lengthy seasoning required by the NAIC accreditation system.

Other Concerns

A companion concern for the NAMIC membership and other non-public insurers is the possibility of incorporation of content from the Sarbanes-Oxley Act into the professional standard for auditors known currently as Statement on *Auditing Standards No. 60 – Communication of Internal Control Related Matters Noted in an Audit*.

The proposed revision of this auditing standard concentrates on the definition of “reportable conditions,” i.e. shortcomings in internal accounting control, and how and to whom these are to be reported.

The chair of the NAIC/AICPA Working Group has recommended to the AICPA that content from the Act be included. Since this auditing standard is now confined to definitions of reportable conditions and their communication, we believe it is improbable that substantive material from the Act would be built into the revision.

There is also some concern that elements of AT 501, an AICPA attestation standard, could be built into the NAIC Model Audit Rule by one means or another, including a proposed implementation manual that is part of the alternate proposal.

Any effort to do so in the NAIC/AICPA Working Group would almost certainly result in revolt even of those sectors of the industry favoring the alternate proposal. This is apparently understood by the regulator most closely associated with the language of the alternate proposal. He has been scrupulous in hewing to its content and has rebuffed suggestions by other regulators to restore undesirable features of the original proposal.

NAMIC’s Position

NAMIC has worked against this initiative from its debut, and our advocacy has been directly credited for securing changes in the proposal. One of the measure’s most prominent proponents has said “we have listened to NAMIC and that is why this proposal looks like this today.”

Despite these improvements and the fact that many in the insurance industry have endorsed the alternate proposal, the NAMIC Board of Directors voted unanimously to oppose it. Why?

Our opposition has been based on several basic principles:

1. Congress deliberately chose not to subject non-public companies to SOX.
2. SOX was designed to benefit public company investors.
3. All insurers are subject to a rigorous regulatory regime that is designed to address the unique

features of the insurance enterprise. Further, there has been no credible demonstration of regulatory failure requiring extension of SOX to insurers, let alone non-public insurers, which account for less than 5 percent of all insurance company insolvencies.

4. Among public companies, SOX has generated high compliance costs, substantially exceeding initial government estimates. Even the less prescriptive alternate proposal will be costly. The NAIC has failed to estimate or justify these substantial costs, the unjustified burden of which would ultimately be borne by policyholders.

While these principles have resulted in significant mitigation of the NAIC plan, they continue to be inadequately addressed in the alternate proposal.

For example, the fundamental distinction between policyholder and shareholder protection has never been addressed, especially in light of the enormous solvency regulation authority already available to state departments of insurance. The NAIC, in other words, has devised a solution in search of a problem.

Policyholder cost is especially important. NAMIC's analysis of the regulator's original proposal showed a first-year implementation cost of about \$300 million and an 8:1 cost benefit ratio. An analysis by the Virginia Department of Insurance based on NAMIC's cost-benefit study suggests that the first-year implementation costs to policyholders might be about \$80 million, or a ratio of between \$2.50 and \$3.00 of premium for every \$1.00 of benefit manifest as avoided guaranty-fund assessments on surviving insurers. Regulators offer the promise of reduced projected costs but have yet to identify commensurate benefits. A fundamental and practical question remains with respect to regulators' use of the new information they propose: Are already strained state departments of insurance equipped to accept and process this additional material? Will it truly result in a reduced number of insolvencies, or is it one more filing required of insurers that will be only another feature in a regulatory rear-view mirror? An additional question also occurs: Are the changes formerly and currently proposed being mandated specifically for regulators in states where there have been problematic insolvencies? The NAIC must realize that any added requirements

for imposition of systems of internal control and their documentation are labor intensive and costly to insurers. Still to be seen and deliberated on are additional rules for implementation of what would be required of companies under the industry alternate proposal. Again, the matter of cost-benefit, one of the subcommittee's own guiding principles, remains unresolved.

Conclusion

However attractive the alternate proposal might be, it is still subject to later change by regulators who would see to restore more rigorous SOX content for application to non-public insurers, regardless of need or cost. The alternate proposal now in deliberation and its implementation guideline would be the probable vehicle for such restoration. What is scaled back today could be added back at a later date, given regulators' temptation to add more requirements. Similarly, companies below the new \$500 million threshold and now exempt from any requirements could one day grow to a point that they would fall under the provisions, failing indexation of that threshold to recognize price-level changes and economic activity in the insurance sector.

Insurers already in compliance with SOX (SEC registrants for the most part) have demonstrated little sympathy with the arguments that the addition of 404 measures to state solvency regulation for all insurers is unwarranted. Indeed, this has been a recurring theme or problem in discussions among industry representatives regarding compromise with the regulators. This division may increase the possibility that further negotiations, given the participation of SEC registrants, may result in more stringent requirements for non-public insurers.

NAMIC's position has received vital support from Chairmen Michael Oxley and Richard Baker of the U.S. House Financial Services Committee as well as the National Conference of Insurance Legislators and the American Legislative Exchange Council.

That these last two organizations have weighed in is especially important and potentially dispositive. Whatever the NAIC might eventually settle on will be subject to state legislative approval. This notion may be surprising to some: state legislatures make public policy, while insurance regulators implement it. In our judgment, the NAIC's proposal will face long odds in the states.