Applying Sarbanes-Oxley Rules to Mutual Insurance Companies:
A Regulatory Fix in Search of a Real-World Problem

By Robert Detlefsen

To economists and political scientists who study the effects of business regulation, the world of insurance is an enduring mystery. Long after the airline, trucking, railroad, and banking industries were liberated from the shackles of government price controls, insurance products—especially in “personal lines” such as automobile and homeowners insurance—remain subject to various forms of price regulation in nearly every state. Most scholars agree that deregulating insurance prices would increase the availability of coverage, as well as the variety and quality of products offered to consumers. “If a compelling public interest rationale for insurance price regulation does not exist,” asks J. David Cummins of the Wharton School, “how can the persistence of this type of regulation be explained?”

To solve this riddle, one need look no further than the National Association of Insurance Commissioners (NAIC), a private, voluntary organization of insurance regulators from the 50 states, the District of Columbia, and the four U.S. territories. With an annual budget of nearly $59 million and 390 full-time staffers, the NAIC is a bureaucratic colossus whose tentacles reach into virtually every aspect of the insurance business. Lacking direct authority to make policy, it influences the course of insurance regulation by regularly churning out models laws that invariably serve to ratchet up the volume and complexity of insurance regulation. As an interest group that thrives on regulation and the power it bestows, the NAIC regards the concept of deregulation—with respect to prices, underwriting procedures, or virtually anything else related to the business of insurance—as a most unwelcome heresy. Indeed, its track record suggests that the NAIC has never met a regulation it didn’t like.

A case in point is the Sarbanes-Oxley (SOX) Act, a federal securities law designed to protect the interests of shareholders of publicly held companies. A regulatory fix in search of a real-world problem, the Act’s provisions, the NAIC has developed a grand proposal to incorporate elements of SOX into the insurance laws of every state. The SOX-inspired rules would then be applied to thousands of mutual insurance companies—which by definition are non-public companies.

NAIC representatives have argued that grafting SOX provisions onto the already elaborate system of solvency regulation would reduce the extent of insurer insolvencies. One might think, therefore, that the incidence of insolvencies is alarmingly high. In fact, the financial health of the insurance industry has been improving in recent years rather than declining. The number of insurance companies that failed in 2004 declined 48 percent, to 13 compared to 25 insurer insolvencies in 2003, according to Weiss Ratings Inc., an independent provider of ratings and analyses of financial services companies. Three life and health insurers and 10 property and casualty insurers failed in 2004, compared to four and 21, respectively, in 2003. Property and casualty insurer failures in 2004 were at a five-year low.

Even if there was a solvency crisis in the insurance industry, there is no reason to think that applying Sarbanes-Oxley rules would fix the problem. Just as public and non-public companies have different motivations and incentives, securities regulation and insurer solvency regulation have very different purposes. The former is intended to ensure that investors have accurate information about the financial status of the company in which they hold shares. The latter seeks to ensure that the insurer is able to honor its promise to indemnify policyholders according to the terms of their policy agreement. Subjecting non-public insurers to the accounting and governance standards of an inapposite federal securities law in the name of solvency enhancement makes about as much sense as regulating prices in the name of “consumer protection.”

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Purpose and Effects of the Sarbanes-Oxley Act

The Sarbanes-Oxley Act was Congress’s response to the lack of investor confidence that plagued the stock market in the spring of 2002. The financial expansion of the 1990s had ended in March 2000, triggering a period of stock market decline and stagnation. By mid-2002, many market indices had reached six-year lows. To make matters worse, the end of the stock market bubble coincided with a series of sensational corporate governance and accounting scandals, further exacerbating investor malaise and angering the public. With a contentious mid-term election on the horizon, both parties in Congress were eager to demonstrate their intolerance of corporate corruption.

The SOX Act is structured as a series of amendments to the Securities Exchange Act of 1934, and thus applies exclusively to publicly-held companies whose shares are traded on the capital markets. In signing the Act, President Bush underscored its intended purpose by observing that it “says to shareholders that the financial information you receive from a company will be true and reliable.” The law’s caption itself provides a concise summary of its goal: “To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws.” Firms subject to SOX are referred to not as “companies,” but rather as “issuers” of registered securities. Writing in the Wall Street Journal, former Federal Reserve Board Chairman Paul Volcker and former SEC Chairman Arthur Levitt, Jr., observed that “Sarbanes-Oxley was passed to reinforce the duties that directors, executives, and auditors have to the investing public.”

Despite its laudable intent, however, critical assessments of the Act by an array of analysts and commentators have cast doubt on its effectiveness as a shareholder protection tool. According to legal scholar Lawrence Cunningham, many companies were already in compliance with key governance provisions of the Act “as a matter of custom or practice and/or due to requirements imposed by stock exchanges, regulators, state law, or other provisions of federal law.” A survey of the relevant financial and accounting literature by Yale law professor Roberta Romano revealed that the Act’s provisions “are not likely to improve audit quality or otherwise enhance firm performance and benefit investors as Congress intended.”

The Insurance Regulators’ Proposal

If the Act’s provisions do little or nothing to achieve Congress’s objective of improving public companies’ governance and accounting procedures, that alone is reason to doubt that they could be successfully deployed to enhance the solvency of non-public insurance companies. Nevertheless, in the apparent belief that what’s good for corporate shareholders is good for insurance policyholders, the NAIC has come forward with a proposal that would apply Titles II, III, and IV of the Sarbanes-Oxley Act to all insurers.

- Title II governs auditor independence. It amends the Securities Exchange Act of 1934 to prohibit an auditor from performing specified non-audit services contemporaneously with an audit. It also requires pre-approval by the company’s audit committee for those non-audit services that are not expressly forbidden.
- Title III governs corporate responsibility. It makes audit committees of public companies responsible for the appointment, compensation, and oversight of any registered public accounting firm employed to perform audit services. It also requires an audit committee member to be a member of the company’s board of directors, and to be otherwise independent.
- Title IV enhances the financial disclosures required of public companies. Section 404 of this title addresses internal accounting controls.

What will be the effect if these rules are extended to non-public insurance companies? Based on the experience of public companies thus far, Section 404 would be especially problematic. The Securities and Exchange Commission has twice extended the deadline for small public companies and foreign private issuers to comply with Section 404, most recently to July 15, 2006, nearly four years after the Act’s enactment. In a press interview, Treasury Secretary John Snow explained that “the concern is with balance [in enforcing the law]. … [T]he system may have become too prosecutorial, and without enough consultation between and among the regulators and the prosecutors.”
In June 2003, the SEC estimated the economy-wide annual costs of implementing Section 404 to be around $1.24 billion (or $91,000 per company)—not including the cost of the auditor’s attestation report. These projections may have been conservative. Financial Executives International (FEI), a professional membership organization, has conducted two surveys of company costs of compliance with the Section 404 internal controls requirements. Both surveys found that larger firms expected to pay more, both in hours and in dollars, for compliance than smaller firms. However, the projected costs of compliance were larger in relation to revenues for smaller firms than for the larger firms surveyed. The burden of compliance is thus heaviest on smaller firms.

The FEI’s July, 2004 survey puts the average total “year one” cost of compliance per respondent company at over $3 million, of which the average expected increase in outside auditor fees totaled $823,000. If the FEI’s respondents are representative of affected companies as a whole, the total, economy-wide costs of compliance with Section 404 alone could exceed $40 billion. In addition, many public companies report difficulties in attracting and retaining financial experts and outside directors. Both compensation costs and the costs of liability insurance for directors and officers have increased in response to SOX-generated increases in risk.

Mutual Insurance Company Structure and Governance

The public companies that are subject to the SOX Act will ultimately pass these compliance costs on to their customers in the form of higher prices for the goods and services they sell. Mutual insurers would be forced to do the same if the NAIC were to succeed in applying Section 404 requirements to them. However, because the objectives and incentives of non-public companies are very different from those of public companies, the benefits that would accrue to mutual company policyholders are hard to discern.

Unlike mutual insurers, public companies succeed not only by selling their products or services to purchasers, but also by selling shares of their equity to profit-seeking investors. The result is that public companies are often oriented toward short-term goals, such as achieving quarterly earnings targets. Lacking shareholding, mutual insurance companies are not subject to the pressures of capital markets. Instead, they face a different type of financial discipline. Free from the demands of profit-seeking investors, mutual insurance companies concentrate on maintenance of capital and revenues rather than on short-term earnings targets.

Like public company shareholders, the policyholders of a mutual insurance company are considered to be “owners” of the company. However, there are important distinctions between public company stock ownership and the concept of ownership as it applies to a mutual insurance company policyholder. The owner of a share of corporate stock has the right to dispose of that property. In contrast, mutual insurance company policyholders do not have the ability to sell or “cash out” an individual membership interest. Value to the policyholder is realized instead through the mutual company’s ability to meet its promise to indemnify the policyholder’s losses according to the terms of the insurance contract. An elaborate system of solvency regulation has been developed over the last 160 years to ensure that companies maintain sufficient reserves to make good on that promise.

Stock companies and mutual companies also differ substantially in the way they are governed. Whereas the interests of shareholders and corporate executives often diverge in a public company setting, the goals of mutual insurance company boards, executives, and policyholders are closely aligned: all of these parties share a common interest in maintaining the company’s ability to pay claims. No one party stands to benefit from accounting machinations that would harm the other parties or impair the solvency of the company. Yet the NAIC’s SOX-inspired proposal would inexplicably require boards of directors to be independent from the company’s management, as if these differences between public companies and nonpublic companies didn’t exist.

What Should Policymakers Do?

The difficulties that have arisen in the areas of enforcement and compliance is reason enough for state policymakers to think twice before adopting the Sarbanes-Oxley Act as a model. Moreover, the pretext for the NAIC’s SOX proposal—that it is needed to reduce the incidence of insurer insolvencies—does not stand up to scrutiny. There is no reason to believe that the existing system of solvency regulation is inadequate, and even less reason to believe that applying Sarbanes-Oxley rules to non-public (i.e., mutual) insurance companies—a business sector to which it is wholly unsuited—would improve that system. This is not to say, however, that current solvency rules could
not be strengthened. To that end insurance regulators should consider undertaking a process that would consist of:

- Conducting a detailed nationwide study of the causes and effects of insurer insolvencies across the country;
- Examining the existing body of financial regulation law to identify what shortcomings, if any, can be linked to recent insolvencies; and
- Developing targeted, cost-effective remedies to address the identified shortcomings.

Until and unless such an evaluation is complete, state regulators and legislators should reject proposals to apply investor-oriented protections to mutual insurance companies.

Endnotes


6 Ibid., Section 2 (a)(7). “The term ‘issuer’ means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under section 12 of that Act (15 U.S.C. 78l), or that is required to file reports under section 15(d) (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn.”


10 Publicly-traded insurance companies are already subject to the 2002 federal Act, the NAIC version would apply to them as well as to non-public insurers.


